INTRODUCTION

The criteria used to assign quality ratings to extensions of credit that exhibit potential problems or well-defined weaknesses are primarily based upon the degree of risk and the likelihood of orderly repayment, and their effect on a bank's safety and soundness. Extensions of credit that exhibit potential weaknesses are categorized as ''special mention,'' while those that exhibit well-defined weaknesses and a distinct possibility of loss are assigned to the more general category of ''classified.'' The term classified is subdivided into more specific subcategories ranging from least to most severe: ''substandard,'' ''doubtful,'' and ''loss.'' The amount of classified extensions of credit as a percent of capital represents the standard measure of expressing the overall quality of a bank's loan portfolio.

These classification guidelines are only applied to individual credits, even if entire portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each extension of credit should be based upon the fundamental characteristics affecting the collectibility of that particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits in the same industry that are not affected by the problems of the troubled sector(s).

ASSESSMENT OF CREDIT QUALITY

The evaluation of each credit should be based upon the fundamentals of the particular credit, including, at a minimum—

- the overall financial condition and resources of the borrower, including the current and stabilized cash flow (capacity);
- the credit history of the borrower;
- the borrower's or principal's character;
- the purpose of the credit relative to the source of repayment; and
- the types of secondary sources of repayment available, such as guarantor support and the collateral's value and cash flow, when they are not a primary source of repayment. (Undue reliance on secondary sources of repayment should be questioned, and the bank's policy about permitting such a practice should be reviewed.)

The longer the tenure of the borrower's extension of credit or contractual right to obtain funds, the greater the risk of some adverse development in the borrower's ability to repay the funds. This is because confidence in the borrower's repayment ability is based upon the borrower's past financial performance as well as projections of future performance. Failure of the borrower to meet its financial projections is a credit weakness, but does not necessarily mean the extension of credit should be considered as special mention or be classified. On the other hand, the inability to generate sufficient cash flow to service the debt is a well-defined weakness that jeopardizes the repayment of the debt and, in most cases, merits classification. When determining which credit-quality-rating category is appropriate, the examiner should consider the extent of the shortfall in the operating figures, the support provided by any pledged collateral, and/or the support provided by cosigners, endorsers, or guarantors.

Delinquent Extensions of Credit

One of the key indicators of a problem credit is a borrower's inability to meet the contractual repayment terms of an extension of credit. When this occurs, the extension of credit is identified as past due or delinquent. Examiners divide delinquent credits into two main categories for the purpose of a bank examination: ''A'' delinquent extensions of credit and ''B'' delinquent extensions of credit. Extensions of credit are also referred to as ''paper'' because the legal obligation, for example the note, loan, or credit agreement, is typically recorded on a paper form. The designation of ''A'' paper is given to any extension of credit that is considered to be a statutory bad debt. Statutory bad debts are defined in section 5204 of the Revised Statutes (12 USC 56) as all debts due to a bank on which interest is past due and unpaid for a period of six months, unless the extension of credit is well secured and in the process of collection. Delinquent credits that are not covered under the definition of statutory bad debt are designated as ‘‘B’’ paper. In either case, special mention or classified extensions of credit are often found to be delinquent. An extension of credit that is *not* delinquent also may be identified as special mention or classified. Nondelinquent extensions of credit (also referred to as ‘‘performing’’ or ‘‘current’’) should be classified when well-defined weaknesses exist that jeopardize repayment. Examples of well-defined weaknesses include the lack of credible support for full repayment from reliable sources, or a significant departure from the intended source of repayment. This latter weakness warrants concern because a delinquent credit may have been brought current through loan or credit modifications, refinancing, or additional advances.

SPECIAL MENTION CATEGORY

A special mention extension of credit is defined as having potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may, *at some future date*, result in the deterioration of the repayment prospects for the credit or the institution's credit position. Special mention credits are not considered as part of the classified extensions of credit category and do not expose an institution to sufficient risk to warrant classification.

Extensions of credit that might be detailed in this category include those in which—

- the lending officer may be unable to properly supervise the credit because of an inadequate loan or credit agreement;
- questions exist regarding the condition of and/or control over collateral;
- economic or market conditions may unfavorably affect the obligor in the future;
- a declining trend in the obligor's operations or an imbalanced position in the balance sheet exists, but not to the point that repayment is jeopardized; and
- other deviations from prudent lending practices are present.

The special mention category should not be used to identify an extension of credit that has as its sole weakness credit-data or documentation exceptions not material to the repayment of the credit. It should also not be used to list extensions of credit that contain risks usually associated with that particular type of lending. Any extension of credit involves certain risks, regardless of the collateral or the borrower's capacity and willingness to repay the debt.

For example, an extension of credit secured by accounts receivable has a certain degree of risk, but the risk must have increased beyond that which existed at origination to categorize the credit as special mention. Other characteristics of accounts receivable warranting identification as special mention include a rapid increase in receivables without bank knowledge of the causative factors, concentrations in receivables lacking proper credit support, or lack of on-site audits of the bank's borrower.

CLASSIFICATION CATEGORIES

Split Classifications

When classifying a particular credit, it may not be appropriate to list the entire balance under one credit-quality category. This situation is commonly referred to as a ‘‘split classification’’ and may be appropriate in certain instances, especially when there is more certainty regarding the collectibility of one portion of an extension of credit than another. Split classifications may also involve special mention as well as ‘‘pass’’ credits, those that are neither special mention nor classified. Extensions of credit that exhibit well-defined credit weaknesses may warrant classification based on the description of the following three classification categories.[1]

Substandard Extensions of Credit

A ‘‘substandard’’ extension of credit is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Extensions of credit so classified must have a well-defined weakness or

1. Guidelines for the uniform classification of consumer-installment extensions of credit and credit card plans, as well as classification guidelines for troubled commercial real estate credits, are discussed in detail in sections 2130.1 and 2090.1, respectively

weaknesses that jeopardize the liquidation[2] of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard.

Doubtful Extensions of Credit

An extension of credit classified ''doubtful'' has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to the advantage of and strengthen the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors may include a proposed merger or acquisition, liquidation proceedings, capital injection, perfecting liens on additional collateral, or refinancing plans.

Examiners should avoid classifying an entire credit as doubtful when collection of a specific portion appears highly probable. An example of proper use of the doubtful category is the case of a company being liquidated, with the trustee-in-bankruptcy indicating a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the bank. In this situation, estimates are based on liquidation-value appraisals with actual values yet to be realized. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent. A proper classification of such a credit would show 40 percent substandard, 25 percent doubtful, and 35 percent loss.

Examiners should generally avoid repeating a doubtful classification at subsequent examinations, as the time between examinations should be sufficient to resolve pending factors. This is not to say that situations do not occur when continuation of the doubtful classification is warranted. However, the examiner should avoid undue continuation if repeatedly, over the course of time, pending events do not occur and repayment is again deferred awaiting new developments.

Loss Extensions of Credit

Extensions of credit classified ''loss'' are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the credit has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Banks should not be allowed to attempt long-term recoveries while the credit remains on the bank's books. Losses should be taken in the period in which they surface as uncollectible.

In some cases, examiners should determine a reasonable carrying value for a distressed extension of credit and require a write-down through a charge to the allowance for loan and lease losses, or to other operating expenses in the case of an ''other asset.'' Such a determination should be based on tangible facts recorded in the bank's credit file and contained in reports on problem credits submitted to the board of directors or its committee, and not solely on verbal assurances from a bank officer.

SITUATIONS NOT REQUIRING CLASSIFICATION

It is generally not necessary to classify extensions of credit and contingent liabilities that are adequately protected by the current sound worth and debt-service capacity of the borrower, guarantor, or the underlying collateral. Further, a performing extension of credit should not automatically be identified as special mention, classified, or charged off solely because the value of the underlying collateral has declined to an amount that is less than the balance outstanding. Extensions of credit to sound borrowers that are refinanced or renewed in accordance with pru-

2. This terminology is used in the original classification definitions as set forth in the 1938 Accord and its amendments. The term ''liquidation'' refers to the orderly repayment of the debt and not to a forced sale of the loan or its underlying collateral.

dent underwriting standards should not be categorized as special mention unless a potential weakness exists, or classified unless a well-defined weakness exists that jeopardizes repayment. The existence of special mention or classified extensions of credit should not be identified as an imprudent banking practice, as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these extensions of credit.

Partially Charged-Off Extensions of Credit

When an institution has charged off a portion of a credit and the remaining recorded balance of the credit (1) is being serviced (based upon reliable sources) and (2) is reasonably assured of collection, categorization of the remaining recorded balance as special mention or classified may not be appropriate.[3] For example, when the remaining recorded balance of an extension of credit is secured by readily marketable collateral, the portion that is secured by this collateral would generally not be identified as special mention or classified. This would be appropriate, however, if potential or well-defined weaknesses, respectively, continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally receive a credit rating no more severe than substandard.

A more severe credit rating than substandard for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, for example, when significant risk exposures are perceived, such as might be the case in bankruptcy or for credits collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

Formally Restructured Extensions of Credit

Restructured troubled debt should be identified in the institution's internal credit-review system and closely monitored by management. When analyzing a formally restructured extension of credit, the examiner should focus on the ability of the borrower to repay the credit in accordance with its *modified terms*.[4] With formally restructured credits, it is frequently necessary to charge off a portion of the principal, due to the borrower's difficulties in meeting the contractual payments. In these circumstances, the same credit-risk assessment given to nonrestructured credits with partial charge-offs (see the previous subsection) would also generally be appropriate for a formally restructured credit. This includes *not* identifying the remaining recorded balance as special mention or classified if unwarranted. The assignment of special mention status to a formally restructured credit would be appropriate, if, after the restructuring, potential weaknesses remained. It would also be appropriate to classify a formally restructured extension of credit when well-defined weaknesses exist that jeopardize the orderly repayment of the credit, based upon its reasonable modified terms. For a further discussion of troubled debt restructurings, see the glossary section of the Instructions for the Consolidated Reports of Condition and Income and "Loan Portfolio Management," section 2040.1.

ROLE OF GUARANTEES

The primary focus of a review of an extension of credit's quality is the original source of repayment and the borrower's ability and intent to fulfill the obligation without reliance on guarantors.[5] In situations involving troubled credits, however, the assessment of credit quality should also be based upon the support provided by guarantees. As a result, the lending institution

3. The accrual/nonaccrual status of the credit must continue to be determined in accordance with the glossary section of the Instructions for the Consolidated Reports of Condition and Income (call report). Thus, while these partially charged-off credits may qualify for nonaccrual treatment, cash-basis recognition of income will be appropriate when the criteria specified in the call report guidance are met.

4. An example of a restructured commercial real estate credit that does *not* have reasonable modified terms would be a mortgage that requires interest payments *only*, but no principal payments, despite the fact that the underlying collateral generates sufficient cash flow to pay both.

5. Some credits are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the credit based upon the guarantor's ability to repay the credit.

must have sufficient information concerning the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation.

Examiner Treatment of Guarantees

A guarantee should provide support for repayment of indebtedness, in whole or in part, and be legally enforceable. It is predicated upon both the guarantor's financial capacity and willingness to provide support for a credit.

To assess the financial capacity of a guarantor and determine whether the guarantor can honor its contingent liabilities in the event required, examiners normally rely on their own analysis of a guarantor's financial strength. This includes an evaluation of the financial statements and the number and amount of guarantees currently committed to.

A guarantor's willingness to perform is assumed, unless there is evidence to the contrary. Since a guarantee is obtained with the intent of improving the repayment prospects of a credit, a guarantor may add sufficient strength to preclude or reduce the severity of the risk assessment.

Examiners should consider and analyze the following guarantee-related factors during the course of their review of extensions of credit:

- The degree to which the guarantors have demonstrated their ability and willingness to fulfill previous guarantees.
- Whether previously required performance under guarantees was voluntary or was the result of legal or other actions by the lender. Examiners should give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee under review.
- The economic incentives for performance by guarantors. This includes—
  - — guarantors who have already partially performed under the guarantee;
  - — guarantors who have other significant investments in the project;
  - — guarantors whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
  - — guarantees collateralized by readily marketable assets that are under the control of a third party.
- The extent to which guarantees are legally enforceable, although in general this is the only type of guarantee that should be relied upon.
  - — Collection of funds under a guarantee should not be subject to significant delays or undue complexities or uncertainties that might render legal enforceability questionable.
  - — Although the bank may have a legally enforceable guarantee, it may decide not to enforce it. The examiner's judgment should be favorably affected by previous extensions of credit evidencing the timely enforcement and successful collection of guarantees.
- The type of the guarantee. Some guarantees for real estate projects are limited in that they only pertain to the development and construction phases of a project. As such, these limited guarantees cannot be relied upon to support a troubled credit after the completion of these phases.

OFF-BALANCE-SHEET ITEMS

The principal off-balance-sheet credit-related transactions likely to be encountered during loan reviews are loan commitments, commercial letters of credit, and standby letters of credit. When evaluating off-balance-sheet credit transactions for the purpose of assigning a credit-quality rating, the examiner should carefully consider whether the bank is irrevocably committed to advance additional funds under the credit agreement. If the bank must continue to fund the commitment and a potential weakness exists that, if left uncorrected, may at some future date result in the deterioration of repayment prospects or the bank's credit position, the amount of the commitment may be categorized as special mention. If there is a well-defined weakness that jeopardizes repayment of a commitment, classification may be warranted. If an amount is classified, it should be separated into two components: the direct amount (the amount that has already been advanced) and the indirect amount (the amount that must be advanced in the future).

Loan Commitments

Loan commitments are defined as legally binding obligations to extend credit (other than in the form of retail credit cards, check credit, and related plans) for which a fee or other compensation is typically received. Different types of loan commitments vary based upon the nature of the credit granted. Loan-commitment credit risk stems from the possibility that the creditworthiness of the customer will deteriorate between the time the commitment is made and the funds are advanced. (See ''Contingent Claims from Off-Balance-Sheet Activities,'' section 4110.1.)

Commercial Letters of Credit

Commercial letters of credit involve a buyer of goods and a seller of goods and are instruments issued by a bank serving as an intermediary between the two for the resultant payment for the goods. Commercial letters of credit are customarily used to facilitate international trade due to the distances involved, as well as differences in legal, political, and business practices. Additionally, there may be a lack of familiarity between the buyer and seller. As a result, the bank substitutes its credit in place of the buyer's credit and promises on behalf of its customer to pay predetermined amounts of money to the seller against the delivery of documents indicating shipment of goods and representing title to those goods. If the shipping documents are in order, the bank is obligated to pay the seller through the issuance of a sight or time draft. The bank is then reimbursed by its customer for the amount of the shipment plus a fee for conducting the transaction.

Given the nature of the bank's commitment to pay for the goods on behalf of its customer, a commercial letter of credit is typically irrevocable. This means that it cannot be cancelled or revoked without the consent of all parties concerned. As a result, there is added credit risk for the issuing bank since it cannot cancel its commitment in the event the credit standing of its customer deteriorates, even if the deterioration occurs before the shipment of the goods.

Standby Letters of Credit

Most standby letters of credit (SLCs) are unsecured and involve substituting the bank's credit standing for that of the bank's customer on behalf of a beneficiary. This occurs when the beneficiary needs to ensure that the bank's customer is able to honor its commitment to deliver the goods or services by the agreed-upon time and with the agreed-upon quality. For credit-analysis purposes, SLCs are to be treated like loans and represent just one type of extension of credit relative to the overall exposure extended by the bank to the borrower. SLCs can be divided into two main groups: ''financial SLCs'' and ''nonfinancial SLCs.'' Financial SLCs essentially guarantee repayment of financial instruments and are commonly used to ''guarantee'' payment on behalf of customers, issuers of commercial paper, or municipalities (relative to tax-exempt securities). Nonfinancial SLCs are essentially used as bid and performance bonds to ''guarantee'' completion of projects, such as building or road construction, or to guarantee penalty payment in case a supplier is unable to deliver goods or services under a contract.

REQUIRED LOAN WRITE-UPS

A full loan write-up (see criteria below) is required for all significant or material classified or specially mentioned assets if (1) management disagrees with the disposition accorded by the examiner, or (2) the institution will be rated composite 3, 4, or 5. The write-ups will be used to support the classifications to management and, in the case of problem banks, to support any necessary follow-up supervisory actions.

An abbreviated write-up may be appropriate for other loans to illustrate a credit-administration weakness or to formalize certain decisions, document agreements, and clarify action plans for management. For example, bank management may have agreed to either collect or charge off a loan classified doubtful by the next call report date or to reverse interest accruals and place the loan on nonaccrual status. These agreements may be expressed in the report through a brief comment under the classification write-up.

The examiner may find it beneficial to list extensions of credit alphabetically by department and/or branch. When more than one borrower is relevant to a single write-up, the alphabetization of the prime borrower or the parent corporation should determine the credit's position in the list. All other parties to the credit, including cosigners, endorsers, and guarantors, should be indicated directly under the maker of the notes or embodied within the write-up.

Although classifications and items listed for special mention may be listed alphabetically on the report page, examiners may elect to format the listing or write-ups in other ways to illustrate examination findings or conclusions. For example, examiners may wish to group classifications into categories of weakness and to use these listings to support loan-administration comments without providing a write-up for each classified item.

Notwithstanding this guidance, examiners have the flexibility of writing up more than the criticized assets, including any special mention credits, if deemed necessary. The decision to increase the number of write-ups should be based on factors such as the overall financial condition of the bank, quality of the loan portfolio, or adequacy of loan portfolio administration.

It is important that a sufficient number of write-ups with appropriate content be provided to support the examiner's assessment of the bank's problem loans, leases, and other extensions of credit. The write-ups should also support any comments pertaining to credit-administration policies and practices as they relate to this component of the bank's loan portfolio.

General Guidelines for Write-Ups of Special Mention and Classified Extensions of Credit

Extension of credit write-ups may be in a narrative or bullet format, similar to the write-ups of shared national credits, where appropriate. When the special mention or classified credit consists of numerous extensions of credit to one borrower, or when multiple borrowers are discussed in one write-up, the write-up should be structured to clearly identify the credit facilities being discussed. For example, each extension of credit could be numbered when multiple credits are involved.

Before a write-up is prepared, the examiner should recheck central information files or other sources in the bank to determine that all of the obligor's debt, including related debt,[6] has been noted and included. The examiner should consider identifying accrued interest receivable as special mention or classified, especially when the cumulative effect on classified percentages is significant or the accrued interest is appropriately classified loss.

Even though the length of a write-up may be limited, the information and observations contained in the write-up must substantiate the credit's treatment as a special mention or classified credit. To prepare a write-up that brings out pertinent and fundamental facts, an examiner needs to have a thorough understanding of all the factors relative to the extension of credit. An ineffective presentation of the facts weakens a write-up and frequently casts doubt on the accuracy of the risk assessment. The examiner might consider emphasizing deviations from prudent banking practices as well as loan policy and procedure deficiencies that are pertinent to the credit's problems. When portions of a borrower's indebtedness are assigned to different risk categories, including portions identified as "pass," the examiner's comments should clearly set forth the reason for the split-rating treatment. A full write-up on items adversely classified or listed as special mention must provide sufficient detail to support the examiner's judgment concerning the rating assigned. To ensure that the write-ups provide a clear, concise, and logical discussion of material credit weaknesses, the following minimum categories of information should be presented, preferably in the order listed (see SR-99-24):

1. *A general description of the obligation.*
   - *Amount of exposure (both outstanding and contingent or undrawn) as follows:*
     - — Summarize total related and contingent borrowings, including amounts previously charged off and recovered.
     - — List the borrower's total related liabilities outstanding. Amounts making up this total refer to credits in which the borrower may have a related interest and is directly or indirectly obligated to repay, such as partnerships and joint ventures. The rule for determining what

6. The term "related" refers to direct and indirect obligations.

is included in related debt (aggregating debt), which ultimately has to do with ascertaining compliance with legal lending limits, is governed by state law.

— List and identify the obligor's contingent liabilities to the bank under examination. Contingent liabilities include items such as unadvanced portions of a line of credit or extension of credit (commitments), guarantees or endorsements, and commercial and standby letters of credit. Although contingent liabilities to other lenders represent an important component of the financial analysis of the obligor, they should not be listed in the write-up unless they are particularly relevant to the situation, or are portions of both related and contingent liabilities that represent participations purchased from and sold to other lenders. The latter example should be listed even though the entire relationship may not have been identified as special mention or classified. Additionally, only the classified portion of extensions of credit or contingent liabilities of the bank under examination should be listed in the appropriate column(s) of the classified asset page.

• *The obligor and the obligor's location and type of business or occupation.* For the type of business or occupation of the obligor, indicate whether the business is a proprietorship, partnership, joint venture, or corporation. This information can be used to compare the purpose of the credit with the source(s) of repayment, and to compare the credit's structure with the obligor's repayment ability. The general identification of occupation, such as professional or wage earner, may not be definitive enough, so it may be necessary to indicate that, for example, the extension of credit is to a medical doctor.

Types of businesses may be clearly indicated in the borrower's business name and may not require additional comment. For example, Apex Supermarket and Ajax Sporting Goods Store imply a retail supermarket and a retail sporting goods store. However, examiners should not be misled in their analysis of the credit; likewise, the write-up reviewer should not be misled by assuming that a borrower is necessarily in the same line of business indicated by the borrower's business name. In the preceding example, if the borrower is primarily a wholesale grocery or sporting goods supplier, or if it radically deviates from the type of business indicated in its business name, the situation should be clarified. It is important to state the borrower's position in the marketing process—manufacturer, wholesaler, or retailer—and to indicate the types of goods or services.

• *Description and value of collateral.* The type of lien, collateral description and its condition and marketability, as well as the collateral's current value, date of valuation, and basis for the valuation, should be included. If values are estimated, the write-up should indicate the source of the valuation, such as the obligor's recent financial statement, an independent appraisal, or an internal management report. If valuations are not available, a statement to that effect should be included. A bank's failure to obtain collateral valuations, when available, is cause for criticism. Also include any other pertinent information that might impede or facilitate the possible sale of the collateral to repay the extension of credit.

When problem borrowers are involved, the sale of the collateral often becomes the sole or primary source of repayment. As a result, the valuation of the collateral becomes especially important when describing the credit, as described in the specific examples below.

If real estate is pledged to secure the credit, the write-up should provide a description of the property, the lien status, the amount of any prior lien, and the appraised value. If multiple parcels are securing the credit, appraised values should be listed for each parcel, including the date of the appraisal and the basis for the value. When bank staff or examiners' challenges to appraisal assumptions are supported, the resulting adjustment in value for credit-analysis purposes should be indicated. If the property held as collateral has tenants, its cash flow should be noted and the financial strength of the major lessees commented upon, if appropriate.

If the collateral represents shares of or an interest in a closely held company, the shares or ownership interest held should be indicated in relation to the total shares outstanding, and the financial condition of the closely held company should be summarized in the write-up. Additionally, the approximate value of the closely held company, as indicated by its financial statements, should be compared for consistency with the value of the company as indicated on the principal's or partner's personal financial statement. The values often do not correlate to the extent they should, which typically indicates overvaluation of the asset on the balance sheet of the entity owning the shares or ownership interest.

If a blanket lien on assets, such as receivables, inventory, or equipment, is pledged as collateral, the current estimated value of each asset type should be shown separately. The basis for these values can come from various sources, which should be indicated:

- — If receivables are pledged as collateral for an asset-based extension of credit, a current aging report and an assessment of the appropriateness of the advance ratio is usually necessary to determine their collectibility and value.
- — If inventory is pledged as collateral for an asset-based extension of credit, an assessment of the appropriateness of the advance ratio is necessary. Additionally, the value varies with the condition and marketability of the inventory.
- — If listed securities or commodities are pledged as collateral, the market value and date of valuation should be noted.

- *Notation if borrower is an insider or a related interest of an insider.*
- *Guarantors and a brief description of their ability to act as a source of repayment.* If the financial strength of guarantors has changed significantly since the initial guarantee of the credit facility, this should be noted. The relationship of the guarantors to the borrower should be identified, including a brief description of the guarantors' ability (financial strength) to serve as a source of repayment independent of the borrower. Any collateral supporting the guarantees should also be stated. See the previous subsection, ''Role of Guarantees,'' and SR-91-24 for further guidance on considering guarantees for credit-analysis purposes.
- *Amounts previously classified.*
- *Repayment terms and historical performance, including prior charge-offs, and current delinquency status (with notation if the credit is currently on nonaccrual status).* Any changes to the original repayment terms, whether initiated by bank management or the obligor, should be detailed with an appropriate analysis of the changes included in the write-up. Renewals, extensions, and rewritten notes that deviate from the stated purpose and repayment expectations, as approved by management, should be discussed in light of their effect on the quality of the credit. Restructurings should be discussed in terms of their reasonable objectives, focusing on the prospects for full repayment in accordance with the modified terms.

  It may be prudent to state the purpose of the credit. The purpose can be compared with the intended source of repayment for appropriateness. For example, a working capital extension of credit generally should not depend on the sale of real estate for repayment. Additionally, the obligor's prior business experience should correlate to the credit's purpose.

2. *A summary listing of weaknesses resulting in classification or special mention treatment.*
3. *A reference to any identified deficiencies in the item that will support loan-administration or violation comments elsewhere in the report.* This information may consist of deficiencies in credit and collateral documentation or violations of law that have a material impact on credit quality. Loan-portfolio-administration performance includes, but is not limited to—
   - changes in asset quality since the last examination;
   - the appropriateness of loan-underwriting standards;
   - the adequacy of—
     - — loan documentation;
     - — management information systems;
     - — internal control systems; and
     - — loan-loss reserves;
   - the accuracy of internal loan-rating systems;
   - the ability and experience of lending officers, as well as other personnel managing the lending function; and
   - changes in lending policies or procedures since the last examination.

4. *If management disagrees with the classification, a statement to that effect along with management's rationale.* Information could include selected data from the most recent fiscal and interim financial statements (discussion of items such as leverage, liquidity, and cash flow) when the primary reason for the write-up relates to the borrower's financial condition or operating performance. Cost of goods sold, nonrecurring expenses, dividends, or other items indicating deterioration in the credit quality may also be highlighted. Any stated value of the borrower's encumbered assets should be set off against specific debt to arrive at the unprotected balance, if applicable. In addition, the examiner should identify encumbered assets that are pledged elsewhere.
5. *A concise description of any management action taken or planned to address the weakness in the asset.* The action plan should focus on a concise description of management's workout or action plan to improve the credit's collectibility or to liquidate the debt. Review of the bank's documented workout plan should give an examiner a clear idea of past efforts to improve the prospect of collectibility and management's current efforts and future strategy. The plan should clearly state the bank's goals and corresponding timetable as they appear at that point, including items such as the degree of repayment envisioned and the proceeds anticipated from the sale of the collateral. Based on this information, the examiner should succinctly summarize in the write-up the bank's collection efforts to date and its ongoing plans to address the situation.

Optional Information for Write-ups

At the examiner's discretion, other information may be included in loan write-ups. For example the examiner may want to include current financial information on the borrower, cosigners, and guarantors. The additional information may consist of discussions regarding current balance sheets and operating statements. If discussed, the examiner should indicate whether the financial statements have been audited, reviewed, compiled, or prepared by the borrower, and whether they are fiscal or interim statements. If the statements are audited, the examiner should indicate the type of opinion expressed—unqualified, qualified, disclaimer, or adverse—and whether the auditor is a certified public accountant. If the opinion is qualified, note the reason(s) given by the auditor.

When the examiner includes comments regarding the borrower's financial condition, the comments should always highlight credit weaknesses in a manner that supports the risk assessment. It is important that sufficient detail is provided to identify unfavorable factors. A trend analysis or details of balance-sheet, income-statement, or cash-flow items can be included. The examiner may also include comments when special mention or classified credits may exhibit favorable as well as unfavorable financial characteristics. Both types of pertinent factors may be included in the write-up as long as they are placed in the proper perspective to demonstrate the credit's inherent weaknesses.

INTRODUCTION

The allowance for loan and lease losses (ALLL), often referred to as the loan-loss reserve by the banking industry, is presented on the balance sheet as a contra asset account that reduces the amount of the loan portfolio reported on the balance sheet. The purpose of the ALLL is to absorb estimated credit losses within a bank's portfolio of loans and leases, including all binding commitments to lend. Estimated credit losses are anticipated losses that are reasonably expected to occur but whose amounts or obligors cannot be specifically identified.

All insured depository institutions, except for federally insured branches and agencies of foreign banks, must maintain an allowance that is sufficient to absorb all estimated credit losses contained in the bank's loan and lease portfolio. To ensure that its allowance is maintained at an adequate level, a bank must determine the amount of its estimated credit losses at least quarterly or more frequently, if warranted, by evaluating the collectibility of its loan and lease portfolio, including any accrued and unpaid interest. If the amount of the ALLL is inadequate to absorb the level of estimated credit losses, the bank must make a provision for loan and lease losses. This provision appears as an expense item on the bank's income statement and decreases the net income for that period. The ALLL must always have a credit balance and may not be increased by transfers from undivided profits or any segregation thereof. Once a loan or lease loss becomes identifiable, that is, when available information confirms that a specific loan or lease, or portions thereof, is uncollectible, it is to be promptly charged off against the ALLL. Under no circumstances can loan or lease losses be charged directly to undivided profits and capital reserves. Any recoveries on loans or leases previously charged off must be credited back to the ALLL.

To illustrate these concepts, assume that bank A has a loan and lease portfolio totaling $100 million at the end of year 1 and an ALLL of $1.25 million; thus, its net carrying amount for the loan portfolio on the balance sheet is $98.75 million. Based on its most recent analysis, bank A has determined that an ALLL of $1.5 million is necessary to cover its estimated credit losses as of the end of the fourth quarter. Therefore, in the fourth quarter of year 1, bank A should record a "provision for loan and lease losses" for $250,000, debiting this expense and crediting the ALLL for this amount. Assume further that during the first quarter of year 2, bank A identifies $750,000 in uncollectible loans. It must charge off this amount against the ALLL by debiting the ALLL and crediting the individual loans for $750,000. Also assume that in the same first quarter of year 2, bank A receives $100,000 in cash recoveries on previously charged off loans. These recoveries must be credited to the ALLL in that quarter. Thus, in the first quarter of year 2, bank A's ALLL, which began the year at $1.5 million, will have been reduced to $850,000 ($1,500,000 – $750,000 + $100,000 = $850,000). However, management must also perform its quarterly analysis of the adequacy of the ALLL. Assuming this analysis indicates that an ALLL of $1.2 million is necessary to absorb estimated credit losses that cannot be currently identified, then bank A must make a provision for loan and lease losses of $350,000 to bring its ALLL up to the required amount by the end of the first quarter of year 2.

While the overall responsibility for maintaining the ALLL at an adequate level rests with the bank's senior management and board of directors, the adequacy of the ALLL and management's analysis of it are subject to examiner review. The examiner should make every effort to fully understand a bank's methods for determining the adequacy of its ALLL and should take these methods into account when making a final determination of the adequacy of the ALLL for examination purposes. It is appropriate for the examiner to confer with bank management and any outside accountant or auditor that has advised management on its ALLL review policies or practices.

After completing the examination review of the ALLL, the examiner-in-charge may conclude that the allowance for loan and lease losses is less than adequate. The examiner-in-charge, in rare cases, may also conclude that management has significantly overprovided for the ALLL, thus misstating the bank's financial condition and results of operations. If there is a significant error in either direction, the examiner should discuss these findings with bank management, include appropriate comments in the examination report, and, if the ALLL is inadequate, direct the bank to restore it to an adequate level.

OVERVIEW OF THE INTERAGENCY POLICY STATEMENT

The primary document that governs the determination of the adequacy of the ALLL is the Interagency Policy Statement on the Allowance for Loan and Lease Losses issued December 21, 1993. This policy statement, included at the end of this section, provides institutions and examiners with guidance on the management policies, internal systems, and approaches for estimating adequate loan-loss reserves. The examiner is responsible for ascertaining that the bank under examination is in compliance with the interagency policy statement.

The policy imposes certain responsibilities on examiners to determine (1) the effectiveness of each bank's internal credit-review procedures, (2) the adequacy of its ALLL evaluation techniques, and (3) ultimately, whether its ALLL is sufficient both in terms of the accounting principles used and in the broader context of the safety and soundness of the institution. In applying the terms of the interagency policy statement during individual bank examinations, the examiner must take into account the variations in size, character, and complexity of operation and the different levels of management sophistication among state member banks. The principles of the policy statement should always be applied consistently with these factors. Consequently, the ways that individual banks comply with the policy statement will vary greatly from institution to institution. As a general rule, examiners can expect smaller institutions with less diverse operations offering traditional lending products to have much simpler and more abbreviated lending policies and less sophisticated loan review processes than larger and more complex banks. Thus, when determining compliance with the policy statement, the examiner should pay particular attention and give special weight to management's record of success in properly managing the credit function and in identifying problem assets promptly.

Finally, in an attempt to bring consistency to the subjective process of judging credit risk, potential future loan losses, and the adequacy of the ALLL, the policy statement established a uniform standard for judging whether the level of a bank's ALLL is reasonable. The examiner should check the reasonableness of management's ALLL methodology by comparing the reported ALLL (after deducting all identified losses) against the sum of 50 percent of the loans the examiner has classified as doubtful, plus 15 percent of the loans the examiner has classified as substandard, plus an additional amount for unclassified assets. The final amount of this calculation should not be considered a floor or a safe-harbor level for a bank's ALLL. Rather, the examiner should use this amount as a general guide, taking into account the bank's individual circumstances. Examiners should also exercise considerable judgment when evaluating the estimated reserves attributed to the unclassified loan portfolio, keeping in mind the overall management of the loan portfolio, the bank's historical losses on nonclassified loans (if available), concentrations of credit, the strength of the local economy, or any other issue deemed appropriate.

Verification During Examinations of State Member Banks

The examiner's responsibility to determine the adequacy of a bank's ALLL is one of the most important functions of any examination. The examiner must not only verify that the balance of the ALLL as of the examination date is adequate to absorb estimated credit losses that may become specifically identifiable in the future, he or she must also ascertain that the ALLL and related information have been correctly reported in the bank's call report and that management is in compliance with the interagency policy statement and has adequate systems in place to ensure continued compliance.

To carry out this responsibility, the examiner will consider all relevant information (1) developed during current and prior examinations, particularly the results of the examiner's loan review and the level, trend, and type of assets classified during the examination; (2) presented in the Uniform Bank Performance Reports, such as trends and peer data; (3) gleaned from correspondence files and other sources; and (4) developed by the bank as part of its internal credit-review process, internal management information systems, and formal analysis of the adequacy of its ALLL. Other information to be considered by the examiner may include—

- the current level and trend of delinquencies;

- listings of aged past-due loans, loans on which interest is not being collected in accordance with the terms of the loans, and loans whose terms have been modified by reducing or deferring the interest or principal payments;
- excessive loan renewals and extensions;
- the practice of habitual or excessive granting of exceptions to the bank's established underwriting standards;
- the results of discussions with bank officers and employees and the examiner's assessment of their level of competence;
- general or local economic conditions that might have a bearing on the collectibility of loans, such as pronounced business recessions, the closing of an important plant, weather or market factors affecting agriculture, widespread labor strikes, or international trade barriers; or
- all available outside information of comparable nature on banks of similar loan-portfolio size, composition, and quality.

The examiner should remember that loan and lease losses, whether actual or estimated, may vary greatly even among banks with loan portfolios of similar size, composition, and quality. Accordingly, information from peer-group banks should be used only as general guidance and never as the sole determinant of the adequacy of the ALLL.

The examiner will also ascertain that all identifiable losses have been charged off in a timely manner, meaning immediately after a loan has been identified as a loss. For secured loans, it may not be possible to precisely identify the loss until the collateral is liquidated. However, an attempt to estimate the loss should be made based on available information about the value of the collateral. If the collateral is sold shortly after it was received in a foreclosure or repossession, the bank shall substitute the value received at the sale for the fair value estimated at the time of foreclosure or repossession and adjust the loss charged against the ALLL. If an asset received in a foreclosure or repossession is held for longer than a short period of time, any additional losses in value and any gain or loss from the sale or disposition of the asset are not to be reported as a loan or lease loss or recovery, and they shall not be debited or credited to the ALLL. Examiners will need to use their judgment when evaluating whether the gain or loss from the sale of the asset occurred within a short period of time. Additional declines in value and the gain or loss from the sale or disposition shall be treated as other noninterest income or expense in accordance with the call report instructions. When a loan is charged off, all applicable accrued interest should be recognized as loss. Interest that has been accrued year-to-date should be charged against current income, and interest accrued in the prior calendar year should be charged to the ALLL. For discounted loans, the unearned portion of the loan balance should be charged against the unearned discount account.

INTERAGENCY POLICY STATEMENT DATED DECEMBER 21, 1993

Nature and Purpose of the ALLL

Federally insured depository institutions (''institutions'') must maintain an ALLL at a level that is adequate to absorb estimated credit losses associated with the loan and lease portfolio, including all binding commitments to lend.[1] To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated credit losses associated with off-balance-sheet credit instruments such as standby letters of credit.[2]

For purposes of this policy statement, the term ''estimated credit losses'' means an estimate of the current amount of the loan and lease portfolio (net of unearned income) that is not likely to be collected; that is, net charge-offs that are likely to be realized for a loan or pool of loans given facts and circumstances as of the evaluation date. These estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., a provision to the ALLL) set forth in generally accepted accounting principles (GAAP). When available information confirms specific loans and leases, or portions

1. In the case of binding commitments to lend and off-balance-sheet credit instruments, such losses represent the amount of loans and leases that will likely not be collected (given facts and circumstances as of the evaluation date) and, thus, will be charged off. For purposes of this policy statement, the loan and lease portfolio, binding commitments to lend, and off-balance-sheet credit commitments are referred to as ''loans,'' ''loans and leases,'' the ''loan and lease portfolio,'' or the ''portfolio.''

2. Recourse liability accounts (that arise from recourse obligations for any transfers of loans that are reported as sales for regulatory reporting purposes) should be reported as liabilities that are separate and distinct from the ALLL.

thereof, to be uncollectible, these amounts should be promptly charged off against the ALLL.

Estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. For individually analyzed loans, these estimates should reflect consideration of the facts and circumstances that affect the repayment of such loans as of the evaluation date. For pools of loans, estimated credit losses should reflect consideration of the institution's historical net charge-off rate on pools of similar loans, adjusted for changes in trends, conditions, and other relevant factors that affect repayment of the loans in these pools as of the evaluation date. Methodologies for the determination of the historical net charge-off rate on a pool of loans can range from a simple average of an institution's net charge-off experience over a relevant period of years—coupled with appropriate adjustments as noted above for factors that affect repayment—to more complex techniques, such as migration analysis.

As discussed more fully below, for analytical purposes, an institution may attribute portions of the ALLL to individual loans or groups of loans. However, the ALLL is available to absorb all credit losses that arise from the loan and lease portfolio and is not to be segregated for, or allocated to, any particular loan or group of loans.

Responsibility of the Board of Directors and Management

Adequate ALLL Level

It is the responsibility of the board of directors and management of each institution to maintain the ALLL at an adequate level.[3] For purposes of the Reports of Condition and Income (call report) and the Thrift Financial Report (TFR), an adequate ALLL should be no less than the sum of the following items *given facts and circumstances as of the evaluation date* (after deduction of all portions of the portfolio classified loss):

- for loans and leases classified substandard or doubtful, whether analyzed and provided for individually or as part of pools, all estimated credit losses over the remaining effective lives of these loans
- for components of the loan and lease portfolio that are not classified, all estimated credit losses over the upcoming 12 months[4]
- amounts for estimated losses from transfer risk on international loans

Furthermore, when determining the appropriate level for the ALLL, management's analysis should be conservative so that the overall ALLL appropriately reflects a margin for the imprecision inherent in most estimates of expected credit losses. This additional margin for imprecision might be incorporated into the ALLL through the amounts attributed for analytical purposes to individual loans or groups of loans or in a portion of the ALLL that is not attributed to specific components of the loan portfolio.[5]

3. When Financial Accounting Standards Board (FASB) Statement No. 114, "Accounting by Creditors for Impairment of a Loan," becomes effective, an "allowance for losses" must be calculated on a present-value basis when a loan is impaired. FASB Statement No. 114 states that it "does *not* address how a creditor should assess the *overall adequacy* of the allowance for credit losses" (emphasis added), and that, in addition to the allowance for credit losses calculated under FASB Statement No. 114, a creditor should continue to recognize an ALLL necessary to comply with FASB Statement No. 5, "Accounting for Contingencies." Furthermore, the guidance in FASB Statement No. 114 only applies to a subset of the loan and lease portfolio as the term is used in this policy statement (e.g., the FASB standard does *not* apply to leases, binding commitments to lend, and large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment).

In contrast, this policy statement provides guidance on assessing the *overall adequacy* of the ALLL. At a later date, the federal bank and thrift regulatory agencies may issue further guidance on the application of FASB Statement No. 114 in the ALLL evaluation process.

4. In certain circumstances, subject to examiner review, a net charge-off horizon of less than one year from the balance-sheet date may be employed for components of the portfolio that have not been classified. For institutions with conservative charge-off policies, a charge-off horizon of less than one year might be appropriate for pools of loans that are neither classified nor subject to greater than normal credit risk and that have well-documented and highly predictable cash flows and loss rates, such as pools of certain smaller consumer installment or credit card loans. On the other hand, a net charge-off horizon of more than one year for loans that have not been classified might be appropriate until an institution's loan review function and credit-grading system results in accurate and timely assessments of the portfolio. In such situations, an institution should expeditiously correct deficiencies in its loan review function and credit-grading system.

5. As discussed later in this policy statement, institutions are encouraged to segment their loan and lease portfolios into as many components as practical when analyzing the adequacy of the ALLL. Therefore, institutions are encouraged to reflect the margin for imprecision in amounts attributable for analytical purposes to these components of the portfolio, to the extent possible.

The adequacy of the ALLL should be evaluated as of the end of each quarter, or more frequently if warranted, and appropriate provisions made to maintain the ALLL at an adequate level as of each call report or Thrift Financial Report date. This evaluation will be subject to review by examiners.

Related Responsibilities

In carrying out their responsibility for maintaining an adequate ALLL, the board of directors and management are expected to—

- ensure that the institution has an effective loan review system and controls (which include an effective credit-grading system) that identify, monitor, and address asset-quality problems in an accurate and timely manner (To be effective, the institution's loan review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio.);
- ensure the prompt charge-off of loans, or portions of loans, that available information confirms to be uncollectible; and
- ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio that considers all significant factors that affect the collectibility of the portfolio and supports the range of credit losses estimated by this process.

As discussed more fully in attachment 1, it is essential that institutions maintain effective loan review systems, although smaller institutions would not be expected to maintain separate loan review departments. An effective loan review system should work to ensure the accuracy of internal credit-grading systems and, thus, the quality of the information used to assess the adequacy of the ALLL. The complexity and scope of the institution's ALLL evaluation process, loan review system, and other relevant controls should be appropriate in view of the size of the institution and the nature of its lending activities, and provide for sufficient flexibility to accommodate changes in the factors that affect the collectibility of the portfolio.

Analysis of the Loan and Lease Portfolio

In determining the appropriate level of the ALLL, the institution should rely primarily on an analysis of the various components of its portfolio, including all significant credits on an individual basis. When analyzing the adequacy of the ALLL, institutions should segment their loan and lease portfolios into as many components as practical. Each component would normally have similar characteristics, such as risk classification, past-due status, type of loan, industry, or collateral. A depository institution may, for example, analyze the following components of its portfolio and provide for them in the ALLL:

- all significant credits on an individual basis that are classified doubtful (or the institution's equivalent)
- all other significant credits reviewed individually (If no allocation can be determined for such credits on an individual basis, they should be provided for as part of an appropriate pool below.)
- all other loans and leases that are not included by examiners or by the institution's credit-grading system in the population of loans reviewed individually, but are delinquent or are classified or designated special-mention (e.g., pools of smaller delinquent, special-mention, and classified commercial and industrial loans; real estate loans; consumer loans; and lease-financing receivables)
- homogeneous loans that have not been reviewed individually or are not delinquent, classified, or designated as special-mention (e.g., pools of direct consumer loans, indirect consumer loans, credit card loans, home equity lines of credit, and residential real estate mortgages)
- all other loans that have not been considered or provided for elsewhere (e.g., pools of commercial and industrial loans that have not been reviewed, classified, or designated special-mention; standby letters of credit; and other off-balance-sheet commitments to lend)

In addition to estimated credit losses, the losses that arise from the transfer risk associated with an institution's cross-border lending activities require special consideration. Over and above any minimum amount that is required by the Interagency Country Exposure Review Committee to be provided in the Allocated Transfer

Risk Reserve (or charged against the ALLL), the institution must determine that the ALLL is adequate to absorb all estimated losses from transfer risk associated with its cross-border lending exposure. (See attachment 2 for factors to consider.)

Factors to Consider in the Estimation of Credit Losses

As previously mentioned, estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. While historical loss experience provides a reasonable starting point for the institution's analysis, historical losses, or even recent trends in losses are not, by themselves, a sufficient basis to determine the appropriate level for the ALLL. Management should also consider any factors that are likely to cause estimated credit losses associated with the institution's current portfolio to differ from historical loss experience, including, but not limited to—

- changes in lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices;
- changes in national and local economic and business conditions and developments, including the condition of various market segments;[6]
- changes in the nature and volume of the portfolio;
- changes in the experience, ability, and depth of lending management and staff;
- changes in the trend of the volume and severity of past-due and classified loans, and trends in the volume of nonaccrual loans, troubled-debt restructurings, and other loan modifications;
- changes in the quality of the institution's loan review system and the degree of oversight by the institution's board of directors;
- the existence and effect of any concentrations of credit and changes in the level of such concentrations; and
- the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's current portfolio.

Institutions are also encouraged to use ratio analysis as a supplemental check or tool for evaluating the overall reasonableness of the ALLL. Ratio analysis can be useful in identifying divergent trends (compared with the institution's peer group and its own historical practices) in the relationship of the ALLL to classified and nonclassified loans and leases, to past-due and nonaccrual loans and leases, to total loans and binding commitments, and to historical gross and net charge-offs. However, while such comparisons can be helpful as a supplemental check of the reasonableness of management's assumptions and analyses, they are not, by themselves, a sufficient basis for determining the adequacy of the ALLL. In particular, such comparisons do not obviate the need for a comprehensive analysis of the loan and lease portfolio and the factors affecting its collectibility.

Examiner Responsibilities

Examiners will assess the asset quality of an institution's loan and lease portfolio and the adequacy of the ALLL. In the review and classification of the loan and lease portfolio, examiners should consider all significant factors that affect the collectibility of the portfolio, including the value of any collateral. In reviewing the adequacy of the ALLL, examiners will—

- consider the quality of the institution's loan review system and management in identifying, monitoring, and addressing asset-quality problems (This will include a review of the institution's credit-grading system and loan review function);[7]

6. Credit-loss and recovery experience may vary significantly depending upon the business cycle. For example, an overreliance on recent credit-loss experience during a period of economic growth will not result in realistic estimates of credit losses during a period of economic downturn.

7. The review of an institution's loan review system (including credit-grading) by an examiner will usually include tests involving a sample of the institution's loans. If differences noted between examiner credit grades and those of the institution's loan review system indicate problems with the loan review system, especially where the credit grades assigned by the institution are more liberal than those assigned by the examiner, the institution would be expected to make appropriate adjustments to the assignment of its credit grades to the loan and lease portfolio and to its estimate of the ALLL. Furthermore, the institution would be expected to improve its loan review system. (Attachment 1 discusses effective loan review systems.)

- evaluate the ALLL process evaluation that management has followed to arrive at an overall estimate of the ALLL, and the related assumptions made by management, in order to ensure that the institution's historical loss experience and all significant factors that affect the collectibility of the portfolio (including changes in the quality of the institution's loan review function and other factors previously discussed) have been appropriately considered;
- review the overall level of the ALLL and the range of credit losses estimated by management for reasonableness in view of the factors discussed in the prior sections of this policy statement;
- perform a quantitative analysis (e.g., using the types of ratio analysis previously discussed) as a check of the reasonableness of the ALLL; and
- review the adequacy of the documentation that has been maintained by management to support the adequacy of the ALLL.

After analyzing an institution's policies, practices, and historical credit-loss experience, the examiner should further check the reasonableness of management's ALLL methodology by comparing the reported ALLL (after the deduction of all loans, or portions thereof, classified as loss) against the sum of the following amounts:

- 50 percent of the portfolio that is classified doubtful
- 15 percent of the portfolio that is classified substandard
- for the portions of the portfolio that have not been classified (including those loans designated special-mention), estimated credit losses over the upcoming 12 months given facts and circumstances as of the evaluation date (based on the institution's average annual rate of net charge-offs experienced over the previous two or three years on similar loans, adjusted for current conditions and trends)[8]

This amount is neither a floor nor a safe-harbor level for an institution's ALLL. However, examiners will view a shortfall relative to this amount as indicating a need to more closely review management's analysis to determine whether it is reasonable and supported by the weight of reliable evidence and that all relevant factors have been appropriately considered.[9]

In assessing the adequacy of the ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan administration and collection procedures and effective internal systems and controls, the estimation of credit losses will not be precise due to the wide range of factors that must be considered. Further, the ability to estimate credit losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners will generally accept management's estimates in their assessment of the adequacy of the ALLL when management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems in a timely manner; (2) analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner; and (3) established an acceptable ALLL evaluation process that meets the objectives for an adequate ALLL.

After the completion of all aspects of the ALLL review described in this section, if the examiner does not concur that the reported ALLL level is adequate or if the ALLL evaluation process is deficient or based on the results of an unreliable loan review system, recommendations for correcting these problems, including any examiner concerns regarding an appropriate level of the ALLL, should be noted in the report of examination.

8. In cases where the institution has an insufficient basis for determining this amount, the examiner may use the industry-average net charge-off rate for nonclassified loans and leases.

9. The weights of 50 percent and 15 percent for doubtful and substandard loans, respectively, are estimates of the industry's average-loss experience over time on similarly classified credits. Because they represent the average-industry experience, these weights do not take into account idiosyncratic factors that may be important for estimating expected credit losses for a particular institution, such as the composition of its portfolio; the quality of underwriting, collection, and loan review systems; and current economic conditions and trends. *Nor do these weights incorporate any additional margin to reflect the imprecision inherent in estimates of expected credit losses.* Due to such institution-specific factors, including an institution's historical loss experience adjusted for current conditions and trends, in many cases an ALLL exceeding the sum of (a), (b), and (c) above might still be inadequate, while in other cases, the weight of evidence might indicate that an ALLL less than this amount is adequate. In all circumstances, for purposes of the call report or Thrift Financial Report, the reported ALLL should meet the standard for an adequate ALLL set forth in the subsection "Responsibility of the Board of Directors and Management."

ALLL Level Reflected in Regulatory Reports

The agencies believe that an ALLL established in accordance with this policy statement will fall within the range of acceptable estimates developed in accordance with GAAP. When an institution's reported ALLL does not meet the objectives for an adequate ALLL, the institution will be required to increase its provision for loan- and lease-losses expense sufficiently to restore the level of the ALLL reported on its call report or TFR to an adequate level as of the evaluation date.

Attachment 1 to Policy Statement—Loan Review Systems

The nature of loan review systems may vary based on an institution's size, complexity, and management practices. For example, a loan review system may include components of a traditional loan review function that is independent of the lending function, or it may place some reliance on loan officers. In addition, the use of the term ''loan review system'' can refer to various responsibilities assigned to credit administration, loan administration, problem-loan workout, or other areas of an institution. These responsibilities may range from administering the internal problem-loan reporting process to maintaining the integrity of the credit-grading process (e.g., ensuring that changes are made in credit grades as needed) and coordinating the information necessary to assess the adequacy of the allowance for loan and lease losses (ALLL). Regardless of the structure of the loan review system in an institution, at a minimum, an effective loan review system should have the following objectives:

- to promptly identify loans having potential credit weaknesses and appropriately classify loans with well-defined credit weaknesses that jeopardize repayment so that timely action can be taken and credit losses can be minimized
- to project relevant trends that affect the collectibility of the portfolio and isolate potential problem areas
- to provide essential information to determine the adequacy of the ALLL
- to assess the adequacy of and adherence to internal credit policies and loan administration procedures and to monitor compliance with relevant laws and regulations
- to evaluate the activities of lending personnel
- to provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio
- to provide management with accurate and timely information related to credit quality that can be used for financial and regulatory reporting purposes

Credit-Grading Systems

The foundation for any loan review system is accurate and timely credit grading, which involves an assessment of credit quality and leads to the identification of problem loans. An effective credit-grading system provides important information on the collectibility of the portfolio for use in the determination of an adequate level for the ALLL.

Regardless of the particular type of loan review system employed, an effective credit-grading framework generally places primary reliance on loan officers to identify emerging loan problems. However, given the importance and subjective nature of credit grading, a loan officer's judgment regarding the assignment of a particular credit grade to a loan may be subject to review by (1) peers, superiors, or loan committee(s); (2) an independent, qualified part-time or full-time person(s); (3) an internal department staffed with credit review specialists; or (4) outside credit review consultants. A credit-grading review that is independent of the lending function is the preferred approach because it typically provides a more conservative and realistic assessment of credit quality. Because accurate and timely credit grading is a critical component of an effective loan review system, each institution should ensure that its loan review system includes the following attributes:

- a formal credit-grading system that can be reconciled with the framework used by the federal regulatory agencies[10]

10. An institution may have a credit-grading system that differs from the credit-grading framework used by the federal banking agencies. However, each institution that maintains a credit-grading system that differs from the agencies' framework should maintain documentation that translates its credit-

- an identification or grouping of loans that warrant the special attention of management
- documentation supporting the reason(s) why a particular loan merits special attention
- a mechanism for direct, periodic, and timely reporting to senior management and the board of directors on the status of loans identified as meriting special attention and the action(s) taken by management
- appropriate documentation of the institution's credit-loss experience for various components of its loan and lease portfolio[11]

An institution should maintain a written description of its credit-grading system, including a discussion of the factors used to assign appropriate credit grades to loans. Loan credit grades should reflect the risk of credit losses.

In addition, the loan review program should be in writing and reviewed and approved at least annually by the board of directors to evidence their support of and commitment to the system.

Loan Review System Elements

The following discussion refers to the primary activities comprising a loan review system that were previously addressed, ranging from the credit administration function to the independent internal loan review function. An institution's written policy and documentation for its loan review system should address the following elements:

- qualifications of loan review personnel
- independence of loan review personnel
- frequency of reviews
- scope of reviews
- depth of reviews
- review of findings and follow-up
- workpaper and report distribution, including distribution of reports to senior management and the board of directors

Qualifications of loan review personnel. Persons involved in the loan review function should be qualified based on level of education, experience, and extent of formal credit training and should be knowledgeable in both sound lending practices and the institution's lending guidelines for the types of loans offered by the institution. In addition, these persons should be knowledgeable of relevant laws and regulations affecting lending activities.

Independence of loan review personnel. An effective loan review system utilizes both the initial identification of emerging problem loans by loan officers and the credit review of loans by individuals independent of the credit-approval decisions. An important element of an effective system is to place responsibility on loan officers for continuous portfolio analysis and prompt identification and reporting of problem loans. Because of their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid overreliance upon loan officers for identification of problem loans. Institutions should ensure that loans are also reviewed by individuals that do not have control over the loans they review and are not part of, or influenced by anyone associated with, the loan approval process.

While larger institutions typically establish a separate department staffed with credit review specialists, cost and volume considerations may not justify such a system in smaller institutions. In many smaller institutions, an independent committee of outside directors may fill this role. Whether or not the institution has an independent loan review department, the loan review function should report *directly* to the board of directors or a committee thereof (though senior management may be responsible for appropriate administrative functions so long as they do not compromise the independence of the loan review function).

Frequency of reviews. Optimally, the loan review function can be used to provide useful continual feedback on the effectiveness of the lending process in order to identify any emerging problems. For example, the frequency of review of significant credits could be at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality in a

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grading system into the pass/special mention/substandard/doubtful/loss credit-grading framework used by the federal regulatory agencies. This documentation should be sufficient to enable examiners to reconcile the totals for the various credit grades under the institution's system to the agencies' categories listed above.

11. Institutions are encouraged to maintain records of net credit-loss experience for credits in each of the following categories: items not classified or designated as special-mention, special-mention, substandard, doubtful, and loss.

particular type of loan or pool of loans. A system of ongoing or periodic portfolio reviews is particularly important to the ALLL determination process, which is dependent on the accurate and timely identification of problem loans.

Scope of reviews. The review should cover all loans that are significant. Also, the review typically includes, in addition to all loans over a predetermined size, a sample of smaller loans; past-due, nonaccrual, renewed, and restructured loans; loans previously classified or designated as special-mention by the institution or by its examiners; insider loans; and concentrations and other loans affected by common repayment factors. The percentage of the portfolio selected for review should provide reasonable assurance that the results of the review have identified the major problems in the portfolio and reflect its quality as a whole. Management should document that the scope of its reviews continues to identify major problems in the portfolio and reflect the portfolio's quality as a whole. The scope of loan reviews should be approved by the institution's board of directors on an annual basis or when any significant changes to the scope of reviews are made.

Depth of reviews. These reviews should analyze a number of important aspects of selected loans, including—

- credit quality,
- sufficiency of credit and collateral documentation,
- proper lien perfection,
- proper approval by the loan officer and loan committee(s),
- adherence to any loan-agreement covenants, and
- compliance with internal policies and procedures and laws and regulations.

Furthermore, these reviews should consider the appropriateness and timeliness of the identification of problem loans by loan officers.

Review of findings and follow-up. Findings should be reviewed with appropriate loan officers, department managers, and members of senior management, and any existing or planned corrective action should be elicited for all noted deficiencies and identified weaknesses, including the timeframes for correction. All noted deficiencies and identified weaknesses that remain unresolved beyond the assigned timeframes for correction should be promptly reported to senior management and the board of directors.

Workpaper and report distribution. A list of loans reviewed, the date of the review, and documentation (including summary analyses) to substantiate assigned classifications or designations of loans as special mention should be prepared on all loans reviewed. A report that summarizes the results of the loan review should be submitted to the board of directors on at least a quarterly basis.[12] In addition to reporting current credit-quality findings, comparative trends can be presented to the board of directors that identify significant changes in the overall quality of the portfolio. Findings should also address the adequacy of and adherence to internal policies, practices and procedures, and compliance with laws and regulations so that any noted deficiencies can be remedied in a timely manner.

Attachment 2 to Policy Statement—International Transfer Risk Considerations

With respect to international transfer risk, an institution should support its determination of the adequacy of its allowance for loan and lease losses by performing an analysis of the transfer risk, commensurate with the size and composition of the institution's exposure to each country. Such analyses should take into consideration the following factors, as appropriate:

- the institution's loan-portfolio mix for each country (e.g., types of borrowers, loan maturities, collateral, guarantees, special credit facilities, and other distinguishing factors)
- the institution's business strategy and its debt-management plans for each country
- each country's balance-of-payments position
- each country's level of international reserves
- each country's established payment-performance record and its future debt-servicing prospects

12. The board of directors should be informed more frequently than quarterly when material adverse trends are noted.

- each country's sociopolitical situation and its effect on the adoption or implementation of economic reforms, in particular those affecting debt-servicing capacity
- each country's current standing with multilateral and official creditors
- the status of each country's relationships with bank creditors
- the most recent evaluations distributed by the Interagency Country Exposure Review Committee (ICERC) of the federal banking agencies

SUBSEQUENT INTERAGENCY GUIDANCE

In November 1998, the federal banking agencies and the Securities and Exchange Commission (SEC) announced an agreement to work together to promote sound accounting and disclosure practices, while also maintaining allowances at appropriate levels. An interagency letter to financial institutions from the federal banking agencies and the SEC was released March 10, 1999, which reaffirmed the agencies' commitment to support credible financial statements and meaningful disclosures, consistent with generally accepted accounting principles (GAAP). The letter indicates that the agencies will issue additional guidance on appropriate methodologies, supporting documentation, and enhanced disclosures regarding the allowance, and it confirms that the agencies will encourage accounting standard-setters to provide additional guidance related to the ALLL. Additionally, the letter concludes that the SEC and the banking regulators will generally focus on enhancing ALLL practices *going forward*.

After the March 10, 1999, letter was issued, the SEC and the federal banking agencies formed a joint working group to oversee the interagency project to develop enhanced guidance on internal documentation and public disclosures about the allowance. The target date for this guidance is March 2000.

On May 21, 1999, the Federal Reserve Board issued SR-99-13, which reemphasized the need for conservative reserving practices, provided background information that described the March 10 initiatives, and provided background information on emerging points of agreement between the banking agencies and the SEC. As discussed in this SR-letter, banks may reserve conservatively at the higher end of the range of estimated losses when those levels are management's best estimate. Furthermore, unallocated reserves are acceptable under GAAP, and allowance estimates can reflect a margin for imprecision. The SR-letter provides a broader interpretation of an article published by the Financial Accounting Standards Board (FASB) on the ALLL, based on discussions with senior FASB staff. The FASB article addresses the interaction between the two primary accounting standards on the ALLL, FASB Statements No. 5 and 114 (FAS 5 and FAS 114). It clarifies that an allowance calculated under FAS 5 may be required for loans that are not identified as being impaired under FAS 114. The article also specifies that reserve calculations for specific impaired loans under FAS 114 should incorporate evaluation of environmental factors (such as industry, geographic, economic, and political factors). Thus, reserves calculated under FAS 5 should not be required for loans that are determined to be impaired under FAS 114.

On July 12, 1999, the federal banking agencies and the SEC issued an interagency letter to financial institutions (see SR-99-22) to reaffirm the principles outlined in the May 21, 1999, SR-letter. In addition, the letter indicated the SEC does not have a policy of seeking reductions in financial institutions' loan-loss-allowance levels and will consult with the banking agencies as it considers whether to take a significant action regarding an institution's ALLL accounting practices.

Allowance for Loan and Lease Losses

Examination Objectives

Effective date November 1995

Section 2070.2

1. To determine if the policies, practices, procedures and internal controls regarding loan and lease losses and the allowance for loan and lease losses are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To determine compliance with laws and regulations.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

Allowance for Loan and Lease Losses
Examination Procedures
Effective date November 1999

Section 2070.3

1. If selected for implementation, complete or update the Allowance for Loan and Lease Losses section of the Internal Control Questionnaire. To do so, obtain a description of the methods and procedures employed by management to determine the adequacy of the bank's allowance for loan and lease losses and the supporting records maintained.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures and obtain a listing of any audit deficiencies noted in the latest review done by internal/external auditors from the examiner assigned ''Internal Control,'' and determine if appropriate corrections have been made.
4. Obtain or prepare an analysis of the allowance for loan and lease losses (valuation reserve) and the related deferred tax and capital accounts (in prior years referred to as the deferred tax and contingency portions of the reserve) for the period from the last examination date to the current one. Agree beginning and ending balances to the general ledger and review the appropriateness of changes in those accounts.
5. Obtain from the appropriate examiner a list of problem loans as of the examination date, that is, loans which are or may become less than 100 percent collectible, possess more than the normal degree of credit risk, are past due, or require more than normal management supervision.
6. Obtain from the appropriate examiner a detailed list of classified loans identified in the various loan departments.
7. Determine whether the reserve for possible loan losses has been adjusted through the most recent quarter and, if not, suggest that management make such adjustment.
8. If, in the opinion of management, significant changes in the collectibility of loans have occurred since the allowance was last adjusted, suggest that management adjust the allowance through examination date.
9. Evaluate management's determination of the amount necessary to adequately provide for estimated loan losses as of the examination date by considering the following:
   a. known probable losses as determined by a review of the lists of loans obtained in steps 5 and 6 and other pertinent information
   b. information included in the Uniform Bank Performance Report including—
      - historical losses as a percentage of loans outstanding and other relevant factors; and
      - comparison of the allowance ratios of banks of similar loan portfolio size and composition
   c. other procedures necessary in the circumstances
10. Review the following items with appropriate management personnel, or prepare a memo to other examining personnel, for their use in reviewing with management:
    a. internal control exceptions and deficiencies in or noncompliance with written policies, practices, and procedures
    b. uncorrected audit deficiencies
    c. inadequate allowance for possible loan and lease losses, if any
11. Request that management make appropriate adjustments to the allowance for loan and lease losses.
    a. Determine the materiality of the change and the need to file amended financial reports.
    b. Provide information to the examiner reviewing regulatory reports, if appropriate.
12. Prepare comments for the examination report regarding the allowance for loan and lease losses, and include any deficiencies reviewed with management and any remedial actions recommended.
13. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures relating to the allowance for loan and lease losses (valuation reserve) and the determination of its adequacy. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies which:
   a. Establish criteria for determining when a loan is to be charged-off?
   b. Establish procedures for charging off loans?
   c. Establish procedures for periodically reviewing and documenting the adequacy of the valuation portion of the allowance?
   d. Define collection efforts to be undertaken after a loan is charged-off?

LOAN CHARGE-OFFS

*2. Is the preparation and posting of any subsidiary records of loans charged-off performed or reviewed by persons who do not also:
   a. Issue official checks and drafts?
   b. Handle cash?

*3. Are all loans charged-off reviewed and approved by the board of directors as evidenced by the minutes of board meetings?

*4. Are notes for loans charged-off maintained under dual custody?

5. Are collection efforts continued for loans charged-off until the potential for recovery is exhausted?
6. Are periodic progress reports prepared and reviewed by appropriate management personnel for all loans charged-off for which collection efforts are continuing?
7. Are adequate procedures in effect relative to recoveries?

OTHER

*8. Does management review the adequacy of the valuation portion of the allowance and make necessary adjustments prior to preparing public financial statements (at a minimum, on a quarterly basis)?

9. Does management's review encompass and give adequate consideration to:
   a. Past loan loss experience and other pertinent historical data?
   b. Assessment of the effectiveness of lending policies and procedures?
   c. Identification, on an individual loan basis, of significant potential weaknesses within the current loan portfolio and an estimate of related amount of loss?
   d. Changes in the character of the loan portfolio?
   e. Current economic conditions?
   f. Amount of past-due loans on which interest is not being collected in accordance with the terms of the loans, and loans whose terms have been modified by reducing interest rates or deferring interest?
   g. Other information appropriate to the circumstances (if so, explain briefly)?
10. Does management retain documentation of their review?
11. Is accrued interest on loans charged-off also charged-off against the allowance account or reversed against interest income, as appropriate?

CONCLUSION

12. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

13. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

The term ‘‘commercial and industrial loan’’ is commonly used to designate loans to a corporation, commercial enterprise, or joint venture that are not ordinarily maintained in either the real estate or consumer installment loan portfolios. Generally, commercial loans are the largest asset concentration of a state member bank, offer the most complexity, and require the greatest commitment from bank management to monitor and control risks. Proper management of these assets requires a clearly articulated credit policy that imposes discipline and sound loan administration. Since lenders are subject to pressures related to productivity and competition, they may be tempted to relax prudent credit underwriting standards to remain competitive in the marketplace, thus increasing the potential for risk. Examiners need to understand the unique characteristics of the varying types of commercial and industrial loans, as well as how to properly analyze their quality.

Commercial loans are extended on a secured or unsecured basis with a wide range of purposes, terms, and maturities. While the types of commercial and industrial loans can vary widely depending on the purpose of loans made and market characteristics where the bank operates, most commercial and industrial loans will primarily be made in the form of a seasonal or working-capital loan, term business loan, or loan to an individual for a business purpose. This section will provide examiners with a fundamental understanding of secured and unsecured transactions, loan evaluation and coverage techniques, the key principles for assessing credit quality, minimum documentation standards for loan line sheets, and basic bankruptcy law, as well as an overview of sections 23A and 23B of the Federal Reserve Act and tie-in arrangements. Other sections of this manual discuss more specific types of lending.

PRIMARY TYPES OF COMMERCIAL AND INDUSTRIAL LOANS

Seasonal or Working-Capital Loans

Seasonal or working-capital loans provide a business with short-term financing for inventory, receivables, the purchase of supplies, or other operating needs during the business cycle. These types of loans are often appropriate for businesses that experience seasonal or short-term peaks in current assets and current liabilities, such as a retailer who relies heavily on a holiday season for sales or a businesses manufacturing company that specializes in summer clothing. These types of loans are often structured in the form of an advised line of credit or a revolving credit. An advised revocable line of credit is a revocable commitment by the bank to lend funds up to a specified period of time, usually one year. Lines of credit are generally reviewed annually by the bank, do not have a fixed repayment schedule, and may not require fees or compensating balances. In the case of unadvised lines of credit, the bank has more control over advances and may terminate the facility at any time, depending on state law or legal precedents. A revolving credit is valid for a stated period of time and does not have a fixed repayment schedule, but usually it has a required fee. The lender has less control over a revolving credit since there is an embedded guarantee to make advances within the prescribed limits of the loan agreement. The borrower may receive periodic advances under the line of credit or the revolving credit. Repayment of the loans is generally accomplished through conversion or turnover of short-term assets. Interest payments on seasonal loans are usually paid throughout the term of the loan, such as monthly or quarterly.

Seasonal or working-capital loans are intended to be repaid through the cash flow derived from converting the financed assets to cash. The structure of the loans can vary, but they should be closely tied to the timing of the conversion of the financed assets. In most cases, seasonal or working-capital facilities are renewable at maturity, are for a one-year term, and include a clean-up requirement for a period sometime during the low point or contraction phase of the business cycle. The clean-up period is a specified period (usually 30 days) during the term of the loan in which the borrower is required to pay off the loan. While this requirement is becoming less common, it provides the bank with proof that the borrower is not dependent on the lender for permanent financing. It is important to note, however, that an expanding business may not be able to clean up its facility since it may be increasing its current assets.

Analysis of Seasonal and Working-Capital Loans

The analysis of a seasonal loan is best accomplished by a monthly or quarterly review of a company's balance sheet and income statements to identify the peak and contraction phases of the business cycle. The lender should know when the peak and contraction phases are, and the loan should be structured accordingly. The lender's primary objective is to determine whether the advances are being used for the intended purposes (inventories or payables) and not for the acquisition of fixed assets or payments on other debts. Repayments on the facility should also be consistent with the conversion of assets. If the borrower has other loan facilities at the bank, all credit facilities should be reviewed at the same time to ensure that the activity with the seasonal or working-capital facility is not linked to other loans in the bank. Projections of sources and uses of funds are also a valuable tool for reviewing a seasonal or working-capital line of credit and determining the sales cycle.

Quarterly balance-sheet and income statements are very helpful when a comparison is made with the original projections. Other helpful information can be obtained from a review of an aging of accounts receivable for delinquencies and concentrations, a current list of inventory, an accounts-payable aging, and accruals made during the quarter. This information can be compared with the outstanding balance of the facility to ensure that the loan is not overextended and that the collateral margins are consistent with borrowing-base parameters. A borrowing base is the amount the lender is willing to advance against a dollar value of pledged collateral; for example, a bank will only lend up to a predetermined specified percentage of total outstanding receivables less all past-due accounts more than a certain number of days delinquent. A borrowing-base certificate should be compiled at least monthly or more often during peak activity in the facility. When reviewing seasonal loans, examiners should remember that a bank relies heavily on inventory as collateral in the beginning of a company's business cycle and on receivables toward the end of the business cycle. However, in traditional working-capital loans, greater emphasis is usually placed on accounts receivable as collateral throughout the loan's tenure.

Normally, a bank is secured by a perfected blanket security interest on accounts receivable, inventory, and equipment, and on the proceeds from the turnover of these assets. Well-capitalized companies with a good history of seasonal payout or cleanup may be exceptions. An annual lien search, however, would be prudent under this type of lending relationship to detect any purchase-money security interest that may have occurred during the business cycle.

The following are potential problems associated with working-capital and seasonal loans:

- *Working-capital advances used for funding losses.* A business uses advances from a revolving line of credit to fund business losses, including the funding of wages, business expenses, debt service, or any other cost not specifically associated with the intended purpose of the facility.
- *Working-capital advances funding long-term assets.* A business will use working-capital funds to purchase capital assets that are normally associated with term business loans.
- *Trade creditors not paid out at end of business cycle.* While the bank may be paid out, some trade creditors may not get full repayment. This can cause a strained relationship as unpaid trade creditors may be less willing to provide financing or offer favorable credit terms in the future. In turn, the business will become more reliant on the bank to support funding needs that were previously financed by trade creditors.
- *Overextension of collateral.* The business does not have the collateral to support the extension of credit, causing an out-of-borrowing-base situation. Examiners should review borrowing-base certificates to verify that coverage meets the prescribed limitations established by the bank's credit policy for the specific asset being financed.
- *Value of inventory declines.* If a business does not pay back the bank after inventory is converted to cash or accounts receivable, the value of the inventory declines. Other causes of inventory devaluation include obsolescence; a general economic downturn; or, in the case of a commodity, market volatility. Declines in inventory value will commonly put a working-capital facility in an out-of-borrowing-base situation and require the excess debt to be amortized and repaid through future profits of the business.

- *Collectibility of accounts receivable declines.* The increasingly past-due status of accounts receivable or deteriorating credit quality of account customers both result in the noncollection of receivables. This can also cause an out-of-borrowing-base situation for the lending institution.
- *Working-capital advances used to fund long-term capital.* Funds may be inappropriately used to repurchase company stock, pay off subordinated debt holders, or even pay dividends on capital stock.

These situations may cause a loan balance to be remaining at the end of the business cycle. If this should occur, the bank generally has one of three options: (1) Require the unpaid balance to be amortized. This option is, however, dependent on the ability of the business to repay the debt through future profits. (2) Request the borrower to find another lender or require an infusion of capital by the borrower. This is not always a feasible option because of the probable weakened financial condition of the business and ownership under these circumstances. (3) Liquidate the collateral. Foreclosing on the collateral should only be executed when it becomes obvious that the business can no longer function as a going concern. The problem with this option is that once the bank discovers that the business is no longer a viable concern, realizing the full value of the collateral is in jeopardy. The need to resort to any of these options may prompt criticism of the credit.

Term Business Loans

Term business loans are generally granted at a fixed or variable rate of interest, have a maturity in excess of one year, and are intended to provide an organization with the funds needed to acquire long-term assets, such as physical plants and equipment, or finance the residual balance on lines of credit or long-term working capital. Term loans are repaid through the business's cash flow, according to a fixed-amortization schedule, which can vary based on the cash-flow expectations of the underlying asset financed or the anticipated profitability or cash flow of the business. Term business loans involve greater risk than short-term advances because of the length of time the credit is extended. As a result of this greater risk, term loans are often secured. Loan interest may be payable monthly, quarterly, semiannually, or annually.

In most cases, the terms of these loans are detailed in formal loan agreements with affirmative and negative covenants that place certain conditions on the borrower throughout the term of the loan. Generally, loan agreements substantially enhance a borrower/banker relationship because they encourage and promote more frequent communication between the parties. In affirmative covenants, the borrower pledges to fulfill certain requirements, such as maintain adequate insurance coverage, make timely loan repayments, or ensure the financial stability of the business. Negative or restrictive covenants prohibit or require the borrower to refrain from certain practices, such as selling or transferring assets, defaulting, falling below a minimum debt coverage ratio, exceeding a maximum debt-to-equity ratio, or taking any action that may diminish the value of collateral or impair the collectibility of the loan. Covenants should not be written so restrictively that the borrower is constantly in default over trivial issues; however, violations should be dealt with immediately to give credibility to the agreement. Violations of these covenants can often result in acceleration of the debt maturity. A formal loan agreement is most often associated with longer-term loans. If a formal agreement does not exist, the term loans should be written with shorter maturities and balloon payments to allow more frequent review by bank management.

Analysis of Term Business Loans

While a seasonal or working-capital loan analysis emphasizes the balance sheet, the analysis of term loans will focus on both the balance sheet and the income statement. Because a term loan is repaid from excess cash flow, the long-term viability of the business is critical in determining the overall quality of the credit. In evaluating long-term earnings, the examiner must develop a fundamental understanding of the company's industry and competitive position in the marketplace. Most of the analysis will be conducted based on the historical performance of the business and its history of making payments on its debt. Any historical record of inconsistencies or inability to perform on existing debt should prompt an in-depth review to determine the ability of the borrower to meet the loan's contractual agreements. One of the most critical determinations that should be made when evaluating term debt is whether the term of the debt exceeds the useful life of the underlying asset being financed.

While cash flow of the business is the primary source of repayment for a term loan, a secondary source would be the sale of the underlying collateral. Often, if circumstances warrant a collateral sale, the bank may face steep discounts and significant expenses related to the sale. Examiners should carefully consider these issues when evaluating the underlying value of collateral under a liquidation scenario.

The following are potential problems associated with term business loans:

- The term of the loan is not consistent with the useful life of collateral.
- Cash flow from operations does not allow for adequate debt amortization, a fundamental problem that can only be solved by improved performance.
- The gross margin of the business is narrowing, which requires the business to sell more product to produce the same gross profit. Higher sales volume could require more cash for expansion of current assets, leaving less cash for debt amortization. This situation is a common by-product of increased competition.
- Sales are lower than expected. In the face of lower sales, management is unable or unwilling to cut overhead expenses, straining cash flow and resulting in diminished debt-servicing ability.
- Fixed assets that are financed by term loans become obsolete before the loans are retired, likely causing the value of underlying collateral to deteriorate.
- The business's excess cash is spent on higher salaries or other unnecessary expenses.
- The payments on term debt have put a strain on cash flow, and the business is unable to adequately operate or allow natural expansion.
- The balance sheet of the business is weakening. The overall financial condition of the business is deteriorating because of poor performance or unforeseen occurrences in the industry.

Shared National Credits

The Federal Reserve System participates in a program for the uniform review of shared national credits (SNCs). An SNC is defined as any loan or commitment in an original amount of $20 million or more that is (1) shared at its inception by two or more supervised institutions under a formal loan agreement and (2) sold in part to one or more supervised institutions with the purchasing bank assuming its pro rata share of the credit risk. Loans sold to affiliate banks of the same holding company are not part of the SNC program. If the outstanding balance or commitment of an SNC credit falls below $20 million after its inception, and it is not criticized, the credit will not be reviewed at the next review date. Therefore, the examiner should conduct an individual review of the credit at the bank under examination. However, if the former SNC facility fell below the threshold through a charge-off, and was classified or specially mentioned at the most recent SNC review, the credit relationship would continue to be reviewed under the SNC program until such time that the balance falls below $10 million. The Federal Deposit Insurance Corporation (FDIC), the state agencies, and the Office of the Comptroller of the Currency (OCC) also participate in this program. The Federal Reserve carries out the examination of SNCs at the lead or agent banks that are state member banks, state-chartered foreign branches, and credit-extending nonbank subsidiaries of domestic and foreign organizations. The FDIC is primarily responsible for any SNC credits at state nonmember banks, and the OCC supervises the review of those SNCs in which the lead bank is a national bank or an OCC-chartered foreign branch.

SNCs should not be analyzed or reviewed during the examination of the individual participating bank. If the examiner is uncertain whether the credit was reviewed under the SNC program, the respective Reserve Bank coordinator should be contacted. If credits eligible for the program are found but have not been reviewed (other than new SNCs since the time of the last SNC program review), the examiner should submit a memorandum detailing those credits to the respective Reserve Bank coordinator to be forwarded to the SNC coordinator at the Federal Reserve Bank of New York.

SECURED AND UNSECURED TRANSACTIONS

This subsection is intended to be a general reference for an examiner's review of a credit file to determine whether the bank's collateral position is properly documented. Examiners should be aware that secured transactions encompass an extensive body of law that is rather technical in nature. The following discussion contains general information for examiners on the basic laws that govern a bank's security interest in property and on the documentation that needs to be in a loan file to properly document a perfected security interest in a borrower's assets.

Secured Transactions

Most secured transactions in personal property and fixtures are governed by article 9 of the Uniform Commercial Code (UCC). The UCC has been adopted by all 50 states, the District of Columbia, and the Virgin Islands. Timing differences as well as filing locations differ from state to state. Failure to file a financing statement in a timely manner or in the proper location will compromise a lender's security interest in the collateral.

Article 9 of the UCC applies to any transaction that is intended to create a security interest in personal property. Mortgage transactions are not covered, marine mortgages are filed with the Coast Guard, and aircraft liens are filed with the Federal Aviation Administration. A ''security interest'' is defined in the UCC as ''an interest in personal property or fixtures which secures payment or performance of an obligation.'' A secured transaction requires that there be an *agreement* between the parties indicating the parties' intention to create a security interest for the benefit of the creditor or secured party. This agreement is commonly referred to as a security agreement.

Article 9 of the UCC refers to two different concepts related to security interests: attachment and perfection. Attachment is the point in time at which the security interest is created and becomes enforceable against the debtor. Perfection refers to the steps that must be taken in order for the security interest to be enforceable against third parties who have claims against collateral.

Attachment of Security Interest

The three requirements for the creation of a security interest are stated in UCC section 9-203(1). Once the following requirements are met, the security interest attaches:

- The collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement that contains a description of the collateral and, when the security interest covers crops now growing or to be grown or timber to be cut, a description of the land concerned.
- Value has been given to the debtor.
- The debtor has rights in the collateral.

Thus, unless the collateral is in the possession of the secured party, there must be a written security agreement that describes the collateral. The description does not have to be very specific or detailed—''any description of personal property . . . is sufficient whether or not it is specific if it reasonably identifies what is described'' (see section 9-110). The agreement must also be signed by the debtor. The creditor may sign it, but its failure to do so does not affect the agreement's enforceability against the debtor.

''Giving value'' is any consideration that supports a contract. Value can be given by a direct loan, a commitment to grant a loan in the future, the release of an existing security interest, or the sale of goods on contract.

While the debtor must have ''rights'' in the collateral, he or she does not necessarily have to have title to the property. For example, the debtor may be the beneficiary of a trust (the trustee has title of trust assets) or may lease the collateral. The debtor, in such cases, has rights in the collateral, but does not hold the title to the collateral. The secured party, however, only obtains the debtor's limited interest in the collateral on default if the debtor does not have full title to the collateral.

Perfection of Security Interest in Property

Perfection represents the legal process by which a bank secures an interest in property. Perfection provides the bank assurance that it has an interest in the collateral. The category of collateral will dictate the method of perfection to be used. The most common methods of perfection are (1) automatic perfection when the security interest attaches (such as in the case of purchase-money security interests applicable to consumer goods other than vehicles); (2) perfection by possession; (3) the filing of a financing statement in one or more public filing offices (The financing statement is good for five years, and the lender must file for a continuation within the six-month period before expiration of the original statement.) and (4) compliance with a state certificate of title law or central filing under a state statute other than the UCC, such as registration of vehicles.

The most common method of perfecting a security interest is public filing. Public filing serves as a constructive notice to the rest of the world that the bank claims a security interest in certain property of the debtor described in both the security agreement and the financing statement. Public filing is accomplished by filing a financing statement (UCC-1) in a public office, usually the county recorder or secretary of state. The system of filing required by the UCC provides for a notice filing whereby potential creditors can determine the existence of any outstanding liens against the debtor's property.

The form of the financing statement and where to file it varies from state to state. While the filing of a nonstandard form will generally be accepted, the failure to file in the proper public office can jeopardize the priority of the lender's security interest. The UCC provides three alternative filing systems:

- *Alternative System One.* Liens on minerals, timber to be cut, and fixtures are filed in the county land records. All other liens are filed in the office of the secretary of state.
- *Alternative System Two.* The majority of states have adopted this version. It is the same as system one, except liens on consumer goods, farm equipment, and farm products are filed in the county where the debtor resides or in the county where the collateral is located if it is owned by a nonresident.
- *Alternative System Three.* In a minority of states, filings made with the secretary of state must also be filed in the county of the borrower's business (or residence if there is no place of business in that state). Otherwise, the requirement in these states is the same as system two.

As each state may select any of the above three alternatives or a modified version of them, it is important that the examiner ascertain the filing requirements of the state(s) where the bank's customer operates. Most importantly, it is the location of the borrower, not the bank, that determines where the financing statement must be filed.

Evaluation of Security Interest in Property

Key items to look for in evaluating a security interest in property include the following:

- *Security agreement.* There should be a proper security agreement, signed and dated by the borrower, that identifies the appropriate collateral to be secured. It should include a description of the collateral and its location in sufficient detail so the lender can identify it, and should assign to the lender the right to sell or dispose of the collateral if the borrower is unable to pay the obligation.
- *Collateral possession.* If the institution has taken possession of the collateral to perfect its security interest, management of the institution should have an adequate record-keeping system and proper dual control over the property.
- *Financing statement.* If the institution has filed a financing statement with the state or local authority to perfect its security interest in the collateral, in general, it should contain the following information:
  —names of the secured party and debtor
  —the debtor's signature
  —the debtor's mailing address
  —the address of the secured party from which information about the security interest may be obtained
  —the types of the collateral and description of the collateral (Substantial compliance with the requirements of UCC section 9-402 is sufficient if errors are only minor and not seriously misleading. Some states require the debtor's tax ID number on the financing statement.)
- *Amendments.* Not all amendments require the borrower's signature, and banks may file an amendment for the following reasons:
  —borrower's change of address
  —creditor's change of address
  —borrower's name change
  —creditor's name change
  —correction of an inaccurate collateral description
  —addition of a trade name for the borrower that was subsequently adopted

- *Where to file a financing statement.* In general, financing statements filed in good faith or financing statements not filed in all of the required places are effective with respect to any collateral covered by the financing statement against any person with knowledge of the statement's contents. If a local filing is required, the office of the recorder in the county of the debtor's residence is the place to file. If state filing is required, the office of the secretary of state is the place to file.
- *Duration of effectiveness of a financing statement.* Generally, effectiveness lapses five years after filing date. If a continuation statement is filed within six months before the lapse, effectiveness is extended five years after the last date on which the filing was effective. Succeeding continuation statements may be filed to further extend the period of effectiveness.

Perfection of Security Interest in Real Estate

As previously mentioned, real estate is expressly excluded from coverage under the UCC. A separate body of state law covers such interests. However, for a real estate mortgage to be enforceable, the mortgage must be recorded in the county where the real estate covered by the mortgage is located.

Real estate mortgage/deed of trust. When obtaining a valid lien on real estate, only one document is used, the mortgage or deed of trust. The difference between a mortgage and a deed of trust varies from state to state; however, the primary difference relates to the process of foreclosure. A mortgage generally requires a judicial foreclosure, whereas, in some states, a foreclosure on a deed of trust may not. Nearly all matters affecting the title to the real estate, including the ownership thereof, are recorded in the recorder's office.

When determining the enforceability of a real estate mortgage or deed of trust, the examiner should be aware of the following requirements:

- The mortgage must be in writing.
- To be recordable, the mortgage must be acknowledged. There are different forms of acknowledgments for various situations depending on whether individuals, corporations, partnerships, or other entities are executing the mortgage. Make sure that the form of the acknowledgment used is in accordance with the type of individual or entity executing the mortgage.
- If a corporation is the mortgagor, its articles of incorporation or bylaws often will specifically state which officers have authority to sign an instrument affecting real estate. In these instances, the designated officer should be required to sign. If the corporation has a seal, that also must be affixed. If the corporation does not have a seal, this fact must be shown in the acknowledgment.
- As soon as possible after the mortgage is executed, it should be recorded in the office of the recorder for each county in which the property described in the mortgage is located. In most cases, the borrower signs an affidavit that indicates, in part, that he or she will not attempt to encumber the property while the lender is waiting for the mortgage to be recorded. In smaller community banks, common practice may be not to advance any of the money under the loan until the mortgage has been recorded and the later search completed. In larger banks or cities, however, this practice is often not practical.
- If the mortgagor is married, the spouse must join in the execution of the mortgage to subject his or her interest to the lien of the mortgage. If the mortgagor is single, the mortgage should indicate that no spouse exists who might have a dower interest or homestead interest in the property.
- If the mortgagor is a partnership, it must be determined whether the title is in the name of the partnership or in the names of the individual partners. If the title is in the names of the individual partners, their spouses should join in executing the mortgage. If the title is in the name of the partnership, those partners who are required to sign under the partnership agreement should sign.

Unsecured Transactions

Unsecured transactions are granted based on the borrower's financial capacity, credit history, earnings potential, and/or liquidity. Assignment of the borrower's collateral is not required, and repayment is based on the terms and conditions of the loan agreement. While unsecured loans often represent the bank's strongest borrowers, the unsecured loan portfolio can represent its most significant risk. One of the primary concerns related to unsecured credit is that if the borrower's financial condition deteriorates, the lender's options to work out of the lending relationship deteriorate as well. In general, if a credit is unsecured, the file should contain reliable and current financial information that is sufficient to indicate that the borrower has the capacity and can be reasonably expected to repay the debt.

Problem Loans

The following are key signals of an emerging problem loan:

- *Outdated or inaccurate financial information on the borrower.* The borrower is unwilling to provide the financial institution with a current, complete, and accurate financial statement at least annually. Management should also be requesting a personal tax return (and all related schedules) on the borrower. While borrowers will usually present their personal financial statements in the most favorable light, their income tax return provides a more conservative picture.
- *The crisis borrower.* The borrower needed the money yesterday, so the bank advanced unsecured credit.
- *No specific terms for repayment.* The unsecured loan has no structure for repayment, and it is commonly renewed or extended at maturity.
- *Undefined source of repayment.* These types of loans are often repaid through excess cash flow of the borrower, sale of an asset(s), or loan proceeds from another financial institution. These repayment sources are often not identified and are unpredictable.

LOAN-SAMPLING AND COVERAGE REQUIREMENTS

A thorough review of a bank's commercial loan portfolio is one of the most important elements of a bank examination. Credit reviews are an examiner's primary means for evaluating the effectiveness of internal loan review and credit-grading systems, determining that credit is being extended in compliance with internal policies and credit standards, and evaluating the adequacy of the allowance for loan losses. Credit reviews also help the examiner to ascertain a bank's compliance with applicable laws and regulations, judge the safety and soundness of the bank's lending and credit administration functions, and, most important, evaluate directly the quality of the bank's loan portfolio. Since examiners need to make the most efficient use of their time during their on-site review of the loan portfolio, it is not practical to review every loan in the bank's loan portfolio. Instead, examiners must select for review a sample of loans[1] that is sufficient in size and scope to enable them to reach reliable conclusions about the bank's overall lending function. At a minimum, examiners should include in their sample a group of loans referred to as the ''core group,''[2] as described below.

Core Group

Commercial and industrial loans and commercial real estate loans subject to examiner review should include the following:

- All problem loans, including loans that have been previously classified or specially mentioned by the respective Reserve Bank or state banking department during the most recent examinations, loans that are past due as of the date of examination, loans that are on nonaccrual status, loans that have been designated as impaired according to the guidelines set forth in Statement No. 114 of the Financial Accounting Standards Board, loans that are considered renegotiated or restructured debt, and loans that are included on the bank's most recent internal watch list.
- All large loans, defined as loans or aggregations of loans to the same or related borrowers that exceed a dollar cutoff level established by the examiner-in-charge. This cutoff will typically be equal to about 1 percent of a bank's

1. For the purposes of this section, the term ''loans'' includes all sources of credit exposure arising from loans and leases. This exposure includes guarantee, letters of credit, and other loan commitments.

2. If the examiner decides it is practical, the requirements and fundamental guidance set forth in this section can be applied to all types of commercial and industrial loans, as well as to commercial real estate loans or any other type of loan made by the bank.

equity capital, but a higher or lower percentage may be warranted depending on the circumstances of the bank being examined.
- Insider loans, as defined by the Board's Regulation O (12 CFR 215).

This core group of loans (problem loans, special-mention loans, insider loans, and large loans) should represent a substantial portion of the dollar volume of a bank's total commercial and industrial loans and commercial real estate loans. Nevertheless, in the majority of cases, the examiner should select additional loans from the remaining portfolio to be reasonably assured of making an accurate and comprehensive assessment of the condition of the bank's overall loan portfolio and lending activities.[3]

In determining the size and nature of additional loans to be reviewed, the examiner should consider the coverage ratio of the core group of loans.[4] If the core group of loans reviewed constitutes a substantial portion of the total dollar volume of loans (at least 40 to 50 percent), then sufficient additional loans should be reviewed to raise the coverage ratio another 10 percent. If, on the other hand, the coverage ratio of the core group of loans reviewed is lower, primarily because the bank has fewer large loans, then a greater number and higher dollar volume of loans outside the core group should be reviewed. For example, if the coverage of the core group of loans amounts to only 20 to 30 percent, then the loans reviewed in the remaining portfolio should raise the coverage ratio to a minimum of 40 to 50 percent. Loan coverage at the lower end of this range (40 percent) would be appropriate only if the bank—

- is in satisfactory condition,
- has strong asset quality,
- is well-managed, and
- has effective internal risk controls and underwriting standards.

Furthermore, the examiner should not have identified any other matters of significant concern during the examination. In other words, coverage of the core group of loans could be 40 percent only for a bank that received a composite CAMELS rating of 1 or 2 and an asset-quality rating of 1 on its last examination, provided the findings of the current review of the core group of loans appears consistent with these ratings. For banks that have high overall ratings (CAMELS 1 and 2) but a coverage ratio for its core group of loans that is significantly below 40 percent, additional loans should be selected to bring the coverage ratio for all loans reviewed to a minimum 40 percent.

Banking organizations with less than satisfactory composite supervisory ratings or other significant areas of supervisory concern should have loan coverage ratios of at least 55 to 60 percent to fully determine the financial condition of the organization. Any divergence from these guidelines should be fully documented in the confidential section of the examination report.

The examiner should use his or her conclusions from the review of the core group of loans to determine the extent to which additional loans should be selected for review, as these loans will provide the most up-to-date indications of the general condition of the bank's loan portfolio and the adequacy of the bank's credit-administration practices. For example, if the review of the core group of loans reveals that an undue proportion of a bank's problem assets are concentrated in a particular type of loan or if a portion of the portfolio is growing rapidly, the additional loans to be reviewed should be selected from that group.

In determining the extent of additional loans to be reviewed, the effectiveness of the bank's internal credit-review and -grading system should also be considered. If, for example, the examiner's review of the core group of loans provides essentially the same results as those from these systems, then the number and dollar size of the remaining sample reviewed can be kept relatively low (unless the review of the remaining sample raises questions about the integrity of the system with respect to the remaining portfolio).

In addition to the coverage ratio of the core group of loans, an examiner should take into

3. One approach to selecting the additional sample of loans to be reviewed is to lower the cutoff level of larger loans subject to review. Alternatively, other methods (including random sampling or selecting recent loans or specific loan types) may be used to select the sample when these methods appear more suited to the bank's circumstances.

4. A loan-review-coverage ratio should be calculated by dividing the dollar volume of commercial and industrial loans and commercial real estate loans reviewed during the examination by a bank's total dollar volume of such credits. For the purposes of this calculation, loans are defined as all sources of credit exposure arising from loans and leases, including guarantees, letters of credit, and other loan commitments. Credit exposures arising from trading and derivatives activities are not generally included in this coverage ratio.

account other factors, including the overall condition of the bank at its last examination and, most importantly, that examination's findings on the quality of the loan portfolio and the adequacy of loan-administration activities (that is, the accuracy of internal loan-rating systems, the appropriateness of underwriting standards, the adequacy of documentation in files, the adequacy of management information and internal control systems, and the adequacy of loan-loss reserves). Other important factors are the ability and experience of the lending officers and personnel managing the lending function, any changes in asset quality or lending policies since the last examination, and significant concentrations identified in the preliminary review of the loan portfolio. Regardless of the total coverage of the core-group review and the additional sample of loans, the examiner must select a sufficient number, volume, and variety of loans to accurately judge the condition of the bank's entire loan and lease portfolio and the effectiveness of its credit-administration policies and practices.

Commercial Loan Sampling Techniques

Sampling techniques are a valid and efficient method for reviewing the commercial loan portfolios at banks during on-site examinations. Sampling enables the examiner to draw conclusions regarding the condition of the entire loan portfolio by reviewing only a selected portion. These techniques make more efficient use of examination resources and allow examiners to devote more of their time and efforts to other areas of the examination.

Generally, a judgmental sampling technique is used for reviewing commercial loans. This technique enables examiners to evaluate the portfolio by reviewing a desired percentage of all the loans over a preselected cutoff amount. In addition to the judgmental sampling approach, statistical sampling techniques can also be valid methods for evaluating loan portfolios. Two statistical sampling techniques that may be selectively implemented during on-site examinations are attributes sampling and proportional sampling. Attributes sampling is especially well-suited for large banks that have formal loan review programs; proportional sampling may be better suited for smaller or regional banks without internal loan-review programs.

In statistical sampling, the examiner uses the concepts of probability to apply sampling techniques to the design, selection, and evaluation of loan samples. Statistical sampling eliminates (or at least minimizes) potential selection biases because each item in the sample-loan population must have an equal or otherwise determinable probability of being included in the examined portion. This probability provides the examiner with a quantitative, controllable measure of risk.

Generally, statistical sampling techniques may be implemented only in those banks (1) that were found to be in financially sound condition, (2) that were without any undue loan portfolio problems at the latest examination, and (3) where it was determined that the systems and controls were appropriate for implementing such techniques. Moreover, if during an examination, the examiner determines that the statistical sampling results are unsatisfactory, the traditional judgmental sampling technique should be implemented.

The two recommended statistical sampling techniques are described below:

- *Attributes Sampling.* The objective of attributes sampling is to determine from a sample, within specified reliability limits, the validity of the bank's internal loan-review program. The reliability limits are determined by the examiner, who formulates a hypothesis about the bank's loan-review program when evaluating its policies, practices, and procedures for loan extensions. The population to be sampled consists of all loans between certain dollar parameters, except for loans reviewed under the shared national credit program and loans to identified problem industries (the latter are reviewed separately during the examination). The lower dollar parameter is an amount that the examiner deems sufficient to achieve the desired coverage of the loan portfolio and is selected in much the same manner as a cutoff line is chosen in judgmental sampling. The upper dollar parameter is an amount over which all loans must be reviewed because of the significant effect each could have on the bank's capital. Loans are selected from the sample population by using a random digit table.

  When the selected loans are reviewed, the examiner compares his or her grading with those of the bank's loan-review program. An "error" generally exists if the examiner's grading of a particular loan is significantly more severe than the bank's grading. If the error rate in the sample is beyond the pre-established reliability limits the examiner is able to accept, all loans over the cutoff amount should be reviewed. If the examiner is satisfied with the sample results, the bank's internal grading will be accepted for all criticized loans that have not been independently reviewed within the sample population. Even when the bank's internal grading is deemed acceptable by the examiner, any loans reviewed and found to be in error will be appropriately classified in the report.

- *Proportional Sampling.* The procedures for proportional sampling are similar to those followed for attributes sampling. The objective of this sampling technique is to determine whether bank management can identify all the criticizable loans in the portfolio. The examiner formulates a hypothesis about the quality of the examined bank's loan administration, based on an analysis of loan policies, practices, and procedures for loan extensions. In proportional sampling, every loan in the sample population is given an equal chance of selection in proportion to its size, so the larger the loan, the more likely it will be selected for review. Examiners grade the loans in the sample and compare these gradings with the bank's problem-loan list.

  As in attributes sampling, the examiner specifies the desired precision of the sample, that is, that the true error rate in the bank's problem-loan list should be within a certain range of values. A statistical error occurs whenever the examiner criticizes a loan that is not criticized by the bank. If the error rate is higher than expected, the examiner will review all loans over a cutoff line, which is determined using the same criteria as line selection in judgmental sampling. If the sample results indicate an error rate within expectations, then the examiner will accept the bank's problem-loan list as a reliable list of the nonpass loans in the population from which the sample was taken. The examiner will then review and grade each loan on the problem-loan list over the cutoff amount.

For detailed procedures on how to implement both attributes and proportional sampling, examiners should contact either Reserve Bank supervision staff or Federal Reserve Board supervision staff.

REVIEWING CREDIT QUALITY

Importance of Cash Flow

Evaluating cash flow is the single most important element in determining whether a business has the ability to repay debt. Two principal methods of calculating the cash flow available in a business to service debt are presented in this subsection. The results of these methods should be used to determine the adequacy of cash flow in each credit evaluated at an institution. The accrual conversion method is the preferred method because it is the most reliable. The second and less reliable method is the supplemental or traditional cash-flow analysis; however, the information needed for this analysis is usually more obtainable and easier to calculate. The traditional method can be used when circumstances warrant, for example, when the borrower's financial statements are not sufficiently detailed for the information requested in the accrual conversion analysis or when historical information is inadequate.

Analysis and Limitations of Cash Flow

Cash-flow analysis uses the income statement and balance sheet to determine a borrower's operational cash flow. Careful analysis of all investment and financing (borrowing) activities must be made for an accurate assessment of cash flow. In reality, examiners face time constraints that often prevent them from performing the complex mathematical calculations involved in sophisticated cash-flow analysis. Therefore, the cash-flow methods presented below were designed to be reasonable and practical for examiner use. *However, examiners should be careful of conclusions reached using the traditional cash-flow analysis, without consideration to balance-sheet changes or other activities that affect cash flow. The traditional cash-flow analysis does not recognize growth in accounts receivable or inventory, a slow-down in accounts payable, capital expenditures, or additional borrowings.* If the credit file contains a CPA-prepared statement of cash flow or a statement prepared using the accrual conversion method, the examiner should concentrate efforts on reviewing and analyzing these statements rather than on preparing a traditional cash-flow statement.

One critical issue to remember is that deficit cash flow does not always mean that the borrower is encountering serious financial difficulties. In some cases, deficit cash flow is caused by a business's experiencing significant growth, and there is a pronounced need for external financing to accommodate this growth and eliminate the deficit cash-flow position. In this case, an adequate working-capital facility may not be in place to accommodate the need for additional inventory. A comprehensive analysis of changes in the balance sheet from period to period should be made before the loan is criticized.[5]

Components of the Accrual Conversion Method of Cash Flow

Category	*Basis for Amount*
Sales:	Dollar amount of sales in period
+/–change in A/R, INV., A/P:	Represents the absolute difference of the current period from the corresponding period of the previous year in accounts receivable, inventory, and accounts payable.
Formula:	(a) An increase in any current asset is a use of cash and is subtracted from the calculation. Conversely, a decrease in any current asset is a source of cash and is added to the calculation. (b) An increase in any current liability is a source of cash and is added to the calculation. Conversely, a decrease in any current liability is a use of cash and is subtracted from the calculation.
SGA:	Subtract selling, general, and administrative expenses.
Interest Expense:	Add interest expense to the calculation if SGA ''expense'' includes interest expense.
Excess (Deficit) Cash Flow:	Represents cash available before debt service.

5. Examiners should make sure that they are using financial data from consistent periods, that is, year-to-date financial information. Mixing annual financial data with interim financial information can cause misinterpretation of cash flow for a given business cycle or annual period.

Calculation of Supplemental/Traditional Cash Flow

Net Income:	Amount of net income reported on most recent annual income statement before taxes.
Interest Expense:	Add the total amount of interest expense for the period.
Depreciation/ Amortization:	Add all noncash depreciation and principal amortization on outstanding debt.
Cash Flow before Debt Service:	Indicates net Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA). Amortization should include both principal and interest payments required on debt.
Debt Service:	Subtract scheduled principal and interest payments.
Capital Expenditures:	Subtract all capital expenditures for the period.
EQUALS— Excess (Deficit) Cash Flow:	Total amount of excess or deficit cash flow for the period after debt service.
Coverage Ratio:	Cash flow before debt service divided by debt service (principal and interest).

Importance of Financial Analysis

While cash-flow analysis is critical in reviewing whether a borrower has the ability to repay individual debt, a review of the borrower's other financial statements can offer information about other sources of repayment, as well as the borrower's overall financial condition and future prospects. The availability of historical balance-sheet and income information, which allow declining trends to be identified, is critical. Also, it may be appropriate to compare the borrower's financial ratios with the average for the industry overall. Much of the financial information that examiners will review will not be audited; therefore, considerable understanding of general accounting principles is necessary to competently review an unaudited financial statement. The bank should obtain at least annual financial statements from a borrower.

When reviewing a credit file of a borrowing customer of a bank, the following financial information should be available for review: income statement, balance sheet, reconciliation of equity, cash-flow statements, and applicable notes to financial statements. The components for a financial review can be segregated into three areas: operations management, asset management, and liability management. Operations management is derived from the income statement and can be used to assess company sales, cost control, and profitability. Asset management involves the analysis of the quality and liquidity of assets, as well as the asset mix. Liability management covers the analysis of the company's record of matching liabilities to the asset conversion cycle, such as long-term assets being funded by long-term liabilities.

In studying the above forms of management, various ratios will help the examiner form an informed and educated conclusion about the quality of the credit being reviewed. The ratios can be divided into four main categories:

- *Profitability ratios.* These ratios measure management's efficiency in achieving a given level of sales revenue and profits, as well as management's ability to control expenses and generate return on investment. Examples of these ratios include gross margin, operating profit margin, net profit margin, profit to sales ratio, profit to total assets ratio, and direct cost and expense ratios.
- *Efficiency ratios.* These ratios, which measure management's ability to manage and control assets, include sales to assets, inventory days on hand, accounts receivable days on hand, accounts payable days on hand, sales to net fixed assets, return on assets, and return on equity.
- *Leverage ratios.* These ratios compare the funds supplied by business owners with the financing supplied by creditors, and measure debt capacity and ability to meet obligations. These ratios may include debt to assets, debt to net worth, debt to tangible net worth, and interest coverage.
- *Liquidity ratios.* Include ratios such as the current ratio and quick ratio, which measure the borrower's ability to meet current obligations.

Common ''Red Flags''

The symptoms listed below are included to provide an understanding of the common problems or weaknesses examiners encounter in their review of financial information. While one symptom may not justify criticizing a loan, when symptoms are considered in the aggregate, they may help the examiner detect near-term trouble. This list is only a sampling of ''red flags'' that should prompt further review; examiners should also be able to identify issues that may require further investigation from their cursory review of a borrower's financial statement.

- *A slowdown in the receivables collection period.* This symptom often reveals that the borrower has become more liberal in establishing credit policies, has softened collection practices, or is encountering an increase in uncollected accounts.
- *Noticeably rising inventory levels in both dollar amount and percentage of total assets.* Increases in inventory levels are usually supported by trade suppliers, and financing these increases can be extremely risky, particularly if turnover ratios are declining. The increase in inventory levels or lower turnover ratios may also be related to the borrower's natural reluctance to liquidate excessive or obsolete goods at a reduced price. Many businesses are willing to sacrifice liquidity to maintain profit margins.
- *Slowdown in inventory turnover.* This symptom may indicate overbuying or some other imbalance in the company's purchasing policies, and it may indicate that inventory is slow-moving. If the inventory is undervalued, the actual turnover is even slower than the calculated results.
- *Existence of heavy liens on assets.* Evidence of second and third mortgage holders is a sign of greater-than-average risk. The cost of junior

money is high. Most borrowers are reluctant to use this source of funds unless conventional sources are unavailable.

- *Concentrations of noncurrent assets other than fixed assets.* A company may put funds into affiliates or subsidiaries for which the bank may not have a ready source of information on operations.
- *High levels of intangible assets.* Intangible assets, which shrink or vanish much more quickly than hard assets, usually have very uncertain values in the marketplace. In some cases, however, intangible assets such as patents or trademarks have significant value and should be given considerable credit.
- *Substantial increases in long-term debt.* This symptom causes increasing dependence on cash flow and long-term profits to support debt repayment.
- *A major gap between gross and net sales.* This gap represents a rising level of returns and allowances, which could indicate lower quality or inferior product lines. Customer dissatisfaction can seriously affect future profitability.
- *Rising cost percentages.* These percentages can indicate the business's inability or unwillingness to pass higher costs to the customer or its inability to control overhead expenses.
- *A rising level of total assets in relation to sales.* If a company does more business, it will take more current assets in the form of inventory, receivables, and fixed assets. Examiners should be concerned when assets are increasing faster than sales growth.
- *Significant changes in the balance-sheet structure.* These changes may not be the customary changes mentioned previously, but they are represented by marked changes spread across many balance-sheet items and may not be consistent with changes in the marketplace, profits or sales, product lines, or the general nature of the business.

REQUIRED MINIMUM DOCUMENTATION STANDARDS FOR LOAN LINE SHEETS

Certain minimum documentation must appear on all line examination sheets to leave an acceptable audit trail and to support the classification of designated loans. Currently, much of this information is often placed on the line ticket automatically by using computer-based loan-review systems. However, the disposition of the loan and the reasons for that disposition are the most crucial entries on the line ticket. Examiners must document their entries and decide how much of the documentation is required to support the loan-review decision. That decision and a summary of the reasons a loan is passed, listed for special mention, or adversely classified should be provided (preferably in bullet form) on the loan line ticket. Beyond that, the documentation will vary depending on the complexity and profile of the credit. The examiner may provide more detailed information on the collateral, cash flow, and repayment history. This additional information is not mandatory if the rationale for the disposition of the credit is otherwise clear.

The extension of credit line sheets and workpapers should document loan discussion comments, identify the examiner who reviewed the credit, and identify the officer(s) with whom the credit was discussed. Line sheets should also include the examiner's conclusion on the specific credit and the reasons for that conclusion.

As part of a review of examination and supervisory policies and procedures and to promote consistency, the items described below have been implemented as required minimum documentation standards for loan line sheets. These standards recognize a transactional approach in examinations and reflect the efficiencies inherent in a risk-focused approach to examinations. The amount of information that should be documented or included as part of a line sheet may vary depending on the type, complexity, and materiality of the credit. However, all line sheets should include the following information to satisfy the required minimum documentation standards, as set forth by SR-99-25 (“Minimum Documentation Standards for Loan Line Sheets,” September 29, 1999). The first seven items are frequently provided through computer-based loan-review systems.

- *Name and location of borrower.* Document the name of the individual or company responsible for repayment of the debt.
- *Notation if the borrower is an insider or a related interest of an insider.* If the borrower is an insider or a related interest of the insider as defined by Regulation O, reflect this association on the line sheet.
- *Business or occupation.* Briefly describe the legal entity and the type of business in which the company is engaged, according to the

following definitions:

— *Corporation.* A business organization that is owned by shareholders who have no inherent right to manage the business. The organization is generally managed by a board of directors that is elected by the shareholders. The file should contain the borrowing resolution indicating which officers from the corporation are authorized to sign on its behalf. Indicate if the corporation is closely held.

— *Partnership.* A business organization, specifically, an association of two or more persons to carry on as co-owners of a business for profit. Indicate if it is a general partnership (GP) or limited partnership (LP). If GP, each partner is fully liable for the firm's debts and actions. If LP, at least one general partner is fully liable, but there will also be a number of partners whose liability is limited to that enumerated by the partnership agreement. Indicate each partner's proportionate interest (such as 25 or 50 percent).

— *Proprietorship.* A form of business organization that is owned and operated by an individual. If the borrower is an individual, include his or her primary occupation.

- *Loan terms.* Include the following loan information[6]:
  — date of origination (note subsequent renewals and/or extensions)
  — repayment terms (for example, maturity, periodic payments, revolving)
  — maturity (restructured loans should be noted as such)
  — interest rate (fixed or variable) (If variable, state the basis (index) upon which the interest rate is determined.)
  — originated amount of the loan
- *Purpose of loan.* Note the purpose of each credit facility.
- *Repayment source.* Indicate the primary and secondary sources of repayment for each credit facility.
- *Collateral summary and value.* Describe collateral and assess the value of the collateral in which the bank maintains a perfected security interest. Values should be supported by some type of document, such as a recent financial statement, formal appraisal, management estimate, or any publication that maintains a current market value of collateral. At a minimum, the collateral assessment should include the following information:
  — collateral value
  — basis for valuation
  — date of valuation
  — control of collateral
  — current lien status
- *Loan officer assigned to the credit and the internal rating of the credit.* Note the name of the loan officer responsible for the loan. Also document the bank's internal risk-rating. The date of the most recent update of the rating should also be noted. Particular attention should be given to the consistency between the loan classification at the current examination and the assessment provided by the bank's internal loan-review department. Significant disparities should be noted in the asset-quality assessment.
- *Total commitment and total outstanding balances.* Indicate the total amount of the bank's legal commitment or line of credit available to the borrower. Note the total outstanding debt to the borrower as of the date of examination.
- *Examination date.* Indicate the as-of date of the examination.
- *Past-due or nonaccrual status.* Indicate the past-due status (current, nonaccrual, and days past due).
- *Amounts previously classified.* Note the loan amount and how the loan was previously classified at the most recent examination (Federal Reserve Bank or state).
- *Loan disposition (pass, special mention, or adverse classification).* Note the credit amount and how the credit is being classified, such as pass, special mention, substandard, doubtful, or loss.
- *Rationale for examiner's conclusions (preferably in bullet form).* Indicate the reasons for passing the credit or extending it for criticism, which should be consistent with the classification descriptions noted in ''Classification of Credits,'' section 2060.1.
- *Name or initials of the examiner reviewing the credit.* Indicate the name or initials of the examiner who reviewed and assigned the classification to the credit.
- *Any significant comments by, or commitments from, management.* Clearly and specifically indicate relevant comments (including man-

6. If the loan is a shared national credit (SNC), this should be noted on the line sheet. A copy of the SNC write-up should be attached to the line sheet, and it is not necessary to provide any additional data.

agement's disagreement with the disposition of the loan, if applicable) that may be considered when determining whether or not to criticize the credit. Comments can include officer's comments noted in the credit file, information derived from discussions with management, questions the examiner may have about the borrower, or any other item deemed appropriate. If management plans to get out of the credit relationship, a workout strategy should be included in this section. Comments should be included as to why management disagrees with any loan classification or how any loan was classified.
- *Any noted documentation exceptions or loan-administration policy or procedural weaknesses, and any contravention of law, regulation, or policy.* Indicate any documentation exception or violation of law, regulation, or policy that would be appropriate to include as part of the report of examination. The examiner may include any technical exception noted from the credit file that would inhibit the ability of the loan officer or the examiner to make an informed and/or competent judgment about the quality of the credit relationship.

When needed, loan line sheets should briefly note that information is not available or that certain information is not reliable due to deficient loan-administration systems and processes, particularly with respect to loan and collateral documentation and collateral values. If such deficiencies are material, a listing of the exceptions should be noted in the examination report. In addition, the effect of these loan-administration weaknesses should be discussed and factored into the risk-management rating.

Optional Information for Loan Line Sheets

In addition to the above information, additional items should be listed when needed to describe the terms of the credit and/or the disposition accorded to it by the examiners, for example, guarantors, amount of any specific reserve, or amounts previously charged off, as described below:
- *Related debt/tie-ins.* The name, total debt outstanding, and type of borrowings (such as real estate, commercial, installment debt) of the related party might be indicated.
- *Guarantor(s).* If a guarantor exists, the name, amount of the guaranty, and date the guaranty was signed can be noted. A summary and an assessment of data supporting a guaranty may also be included, along with current financial information from the guarantor(s) which the bank should obtain at least annually. Tax returns and supporting schedules, income statements, and other pertinent information on the guarantor(s) may be appropriate under certain circumstances. If a troubled credit, indicate whether the guarantor has exhibited any willingness to financially support the credit.
- *Summary of financial data.* The following information may be appropriate, based on the type and complexity of the loan:
  - — key balance-sheet information (current ratio, D/E ratio)
  - — key income items (EBITDA—earnings before income taxes, depreciation, and amortization; net income; profit margin)
  - — cash-flow coverage (debt-service coverage, interest coverage)
  - — source of financial data (company-prepared balance sheet, audited financial statement)
- *Dates and amounts of previous charge-offs.*
- *Specific reserves.* The examiner may indicate whether an amount (allocated reserve) was specifically set aside to absorb any loss from the credit. When evaluating the overall adequacy of the loan-loss reserve, subtract the aggregate of allocated reserves from the total reserve balance, and subtract the aggregate amount of loans for which allocated reserves exist from the total loan balance.
- *The name of the loan officer who may have offered the most pertinent discussion items that affected the classification decision.*

BANKRUPTCY LAW AND COMMERCIAL LOANS

This section provides examiners with an overview of the United States Bankruptcy Code (the code) chapters that affect commercial and industrial loans. Bankruptcy law is a significant body of law; it would be difficult in this manual to discuss all the issues necessary for comprehensive understanding of the code. This subsection will focus on basic issues that an examiner needs to be familiar with relative to three principal sections of the code: chapters 7, 11, and 13.

Creditors of a Bankrupt Business

A creditor in bankruptcy is anyone with a claim against a bankrupt business, even if a formal claim is not filed in the bankruptcy case. In bankruptcy court, a claim is defined very broadly. A claim may include a right to payment from a bankrupt business, a promise to perform work, or a right to a disputed payment from the debtor that is contingent on some other event. The two basic types of creditors are secured and unsecured. Secured creditors are those with perfected security interest in specific property, such as equipment, accounts receivable, or any other asset pledged as collateral on a loan. Unsecured creditors are generally trade creditors and others who have not taken a specific interest in property supplied to the bankrupt debtor.

Voluntary Versus Involuntary Bankruptcy

When a debtor files a bankruptcy petition, it is described as a voluntary bankruptcy filing. The individual or organization does not have to be insolvent to file a voluntary case. Creditors may also file a bankruptcy petition, in which case the proceeding is known as an involuntary bankruptcy. This form of petition can occur in chapters 7 and 11 bankruptcy cases, and the debtor generally must be insolvent. To be deemed insolvent, the debtor must be unable to pay debts as they mature. However, the code does limit who an involuntary action can be sought against.

Chapter 7—Liquidation Bankruptcy

A chapter 7 action may be filed by virtually any person or business organization that is eligible to file bankruptcy. Chapter 7 bankruptcy can be filed by a sole proprietorship, partnership, corporation, joint stock company, or any other business organization. Restrictions apply to only a few highly regulated businesses, such as railroads, insurance companies, banks, municipalities, and other financial institutions. This chapter is often referred to as ‘‘straight liquidation,’’ or the orderly liquidation of all assets of the entity. Generally, a debtor in a chapter 7 bankruptcy case is released from obligations to pay all dischargeable prebankruptcy debts in exchange for surrendering all nonexempt assets to a bankruptcy trustee. The trustee liquidates all assets and distributes the net proceeds on a pro rata basis against the allowed claims of unsecured creditors. Secured creditor claims are generally satisfied by possession or sale of the debtor’s assets. Depending on the circumstances, a secured creditor may receive the collateral, the proceeds from the sale of the collateral, or a reaffirmation of the debt from the debtor. The reaffirmed debts are generally secured by property that the debtor can exempt from the bankruptcy estate, such as a home or vehicle. The amount of the reaffirmation is limited to the value of the asset at the time of the bankruptcy filing. Some characteristics of a chapter 7 bankruptcy are described below:

- A trustee is appointed in all chapter 7 bankruptcies and acts as an administrator of the bankruptcy estate. The bankruptcy estate that

is established when the petition is filed becomes the legal owner of the property. The trustee acts to protect the interest of all parties affected by the bankruptcy.
- The trustee has control of all nonexempt assets of the bankrupt debtor.
- The trustee is required to liquidate the estate quickly without jeopardizing the interests of the affected parties.
- The proceeds from the sale pay trustee's fees and other creditors. Trustee fees are determined according to the amount disbursed to the creditors and are a priority claim.
- A chapter 7 bankruptcy is typically completed in 90 days, depending on the time needed to liquidate collateral. Some chapter 7 bankruptcies take years to complete.
- The court may allow the trustee to continue to operate a business, if this is consistent with the orderly liquidation of the estate.

Chapter 11—Reorganization

Most major or large businesses filing bankruptcy file a chapter 11 reorganization. As in chapter 7, virtually any business can file a chapter 11 reorganization. There are specialized chapter 11 reorganization procedures for certain businesses such as railroads, and chapter 11 is not available to stockbrokers, commodity brokers, or a municipality. The basic concept behind chapter 11 is that a business gets temporary relief or a reprieve from paying all debts owed to creditors. This temporary relief gives the business time to reorganize, reschedule its debts (at least partially), and successfully emerge from bankruptcy as a viable business. The basic assumption underlying a chapter 11 bankruptcy is that the value of the enterprise as a going concern will usually exceed the liquidation value of its assets.

Reorganization Plan

Generally, the debtor has an exclusive 120-day period to prepare and file a reorganization plan. If the debtor's plan has not been confirmed within 180 days of the bankruptcy filing, a creditor may file a plan. A plan can provide for any treatment of creditor claims and equity interest, as long as it meets the requirements set out in the code. For example, a plan must designate substantially similar creditor claims and equity interest into classes and provide for equal treatment of such class members. A plan must also identify those classes with impaired claims and their proposed treatment. Finally, a method of implementation must be provided. Although plans do not have to be filed by a deadline, the bankruptcy judge will generally place a deadline on the debtor or creditor authorized to prepare the plan.

Some characteristics of a chapter 11 bankruptcy are described below.

- The bankrupt debtor usually controls the business during the bankruptcy proceedings. This arrangement is referred to as "debtor in possession."
- The business continues to operate while in bankruptcy.
- The debtor is charged with the duty of developing a reorganization plan within the first 120 days of the filing. After this period expires, the court may grant this authority to a creditors' committee.
- Once the plan is approved by the bankruptcy court, the debtor's payment of debts is generally limited to the schedule and amounts that are detailed in the reorganization plan.
- A chapter 11 proceeding can be complex and lengthy, depending on the number of creditors, amount of the debts, amount of the assets, and other factors that complicate the proceedings.

Chapter 13—Wage-Earner Bankruptcy

A chapter 13 bankruptcy is available to any individual whose income is sufficiently stable and regular to enable him or her to make payments under the plan. As long as the individual has regular wages or takes a regular draw from his or her business, the individual may qualify under chapter 13 of the code. Under chapter 13, an individual or married couple can pay their debts over time without selling their property. As a protection to creditors, the money paid to a creditor must equal or exceed the amount that the creditor would get in a liquidation or chapter 7 bankruptcy. Chapter 13 may be used for a business bankruptcy, but only if the business is a proprietorship. In most cases, the business needs to be fairly small to qualify.

Some characteristics of a chapter 13 bankruptcy are described below:

- In most cases, only an individual can file a chapter 13 bankruptcy.
- Secured debt may not exceed $350,000.
- Unsecured debt may not exceed $100,000.
- The debtor must propose a good-faith plan to repay as many debts as possible from available income.
- A debtor makes regular payments to a trustee, who disburses the funds to creditors under the terms of the plan.
- The trustee does not control the debtor's assets.
- A chapter 13 bankruptcy may include the debts of a sole proprietorship. The business may continue to operate during the bankruptcy.
- After all payments are made under the plan, general discharge is granted.

SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT

As a result of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the application of sections 23A and 23B of the Federal Reserve Act was expanded to all federally insured commercial and thrift depository institutions. The passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) affected section 23A by allowing the appropriate federal regulator to revoke the ''sister bank'' exemption for all financial institutions that are ''significantly undercapitalized'' or those that are ''undercapitalized'' and fail to submit and implement capital-restoration plans. In addition, FDICIA prohibits critically undercapitalized banks from engaging in covered transactions that are defined in section 23A without prior written approval from the FDIC. Section 23B was added to the Federal Reserve Act on August 10, 1987, through the Competitive Equality Banking Act of 1987. This new section essentially codified additional limitations regarding transactions banks have with their nonbank affiliates. Previously, these transactions had been governed only by Federal Reserve policy or interpretation. The intent of this subsection is to provide examiners with general guidance on how to identify potential violations of these sections of the Federal Reserve Act as it pertains to the commercial-lending function. (Specific guidance and definitions can be obtained from part 1 of the *Federal Reserve Regulatory Service*.)

Section 23A

Section 23A of the Federal Reserve Act was designed to prevent misuse of a bank's resources stemming from non-arm's-length transactions with affiliates. Examiners will first need to determine if the institution and counterparty involved in a transaction are affiliates. Once this relationship is determined, the examiner will need to decide if the transaction is included in the statute as a ''covered transaction.'' Generally, covered transactions within the lending function of the institution would include any loan or extension of credit to an affiliate as defined by section 23A. Any transaction by a bank with any person is deemed to be a transaction with an affiliate to the extent that the affiliate benefited from the transaction. A key element of section 23A is that covered transactions between a bank and its affiliate must be on terms and conditions consistent with safe and sound banking practices.

Once the examiner has determined that the counterparty is an affiliate and that the transaction is a covered transaction, there are quantitative limitations that apply. Section 23A limits the covered transaction between a bank and its affiliate to no more than 10 percent of the bank's capital and surplus (defined as capital stock, surplus, retained earnings, and reserves for loan losses). In addition, an institution and its subsidiaries may only engage in a covered transaction with an affiliate if, in the case of all affiliates, the aggregate amount of the covered transactions of the institution and its subsidiaries will not exceed 20 percent of the capital stock and surplus of the institution.

When the transaction involves an extension of credit to a defined affiliate, certain collateral requirements must also be met. Generally, extensions of credit require certain collateral margins that are tied to the type of collateral. For example, extensions of credit that are secured by U.S. Treasury securities or its agencies require a collateral margin of 100 percent of the transaction amount, whereas collateral consisting of stock, leases, or other real or personal property requires a margin of 130 percent. Some collateral, such as the obligations of an affiliate, is not eligible. Certain exemptions to collateral requirements were included to permit transactions that posed little risk to the bank and to prevent undue hardship among the affiliated organizations in carrying out customary transactions with related entities. These exemptions include various transactions that are related to ''sister bank'' relationships, correspondent relationships, uncollected items, or loans to affiliates secured by riskless collateral.

Section 23B

With respect to affiliates, section 23B defines affiliates in the same manner as section 23A, except that all banks are excluded from section 23B as affiliates. The principal requirements of section 23B state that any transaction between a bank and a defined affiliate under the act must be (1) on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies or (2) in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered or would apply to nonaffiliated companies. In short, the terms and conditions of an extension of credit to an affiliate under section 23B should be no more favorable than those that would be extended to any other borrowing customer of the bank. For covered transactions, all transactions that are covered under section 23A are covered under section 23B; however, section 23B expanded the list to include other transactions such as the sale of securities or the receipt of money or services from an affiliate.

The focus of section 23B is different from that of section 23A. Section 23A contains quantitative and collateral restrictions to protect the bank; section 23B focuses on whether transactions with nonbank affiliates are arm's length and not injurious to the bank. Occasionally, an extension of credit, by definition, is granted to an affiliate of a federally insured bank or thrift institution, so examiners are reminded that it is likely that sections 23A and 23B will be implicated. Essentially, examiners need to keep one basic principal in mind: If money flows from the bank to an affiliate other than through a dividend, the transaction is probably a covered transaction and would be enforceable under sections 23A and 23B.

TIE-IN ARRANGEMENTS

Section 106(b) of the Bank Holding Company Act Amendments of 1970 prohibits banks from directly tying products or services offered by the bank or any of its affiliates. In the typical tie-in arrangement, whether or not credit is extended or a service is provided (or the amount charged for the credit or service) depends upon the customer's obtaining some additional product or service from the bank or its affiliate or providing some additional product or service to the bank or its affiliate. The intent of section 106(b) was to affirm the principles of fair competition by eliminating the use of tie-in arrangements that suppress competition. Specifically, the section prevents banks from using their marketing power over certain products, specifically credit, to gain an unfair competitive advantage. There are two exceptions to the anti-tying restrictions. The bank may vary the consideration charged for a traditional bank product on the condition or requirement that a customer also obtain a traditional bank product from an affiliate. This exception is a limited extension of the traditional-bank-product exception provided in section 106. The second exception applies to securities brokerage services (only those activities authorized under section 225.25(b)(15) of Regulation Y). A bank may vary the consideration charged for securities brokerage services on the condition that a customer also obtain a traditional bank product from that bank or its affiliate.

On April 19, 1995, the Board issued a final rule on the anti-tying provisions of section 106 of the 1970 Bank Holding Company Act Amendments. The rule establishes a ''combined-balance discount'' safe harbor for a banking organization offering varieties of services to its customers and wishing to offer them discounts based on the customers' overall relationship with the bank or its holding company and subsidiaries. The amendment, effective May 26, 1995, provides that a bank holding company or any bank or nonbank subsidiary thereof may weight products as it sees fit in connection with its evaluation of combined-balance discount arrangements, so long as deposits receive an equal or higher weight than other products. The new rule expanded the Board's recent exemption to a large regional banking organization to all banking organizations tying traditional services, such as checking accounts and nontraditional banking products like brokerage services. It permits banks to market products more efficiently and compete more effectively with their nonbanking competitors who currently offer combined-balance discount arrangements.

Examiners should be aware that the principal motive of section 106(b) is to eliminate any potential for ''arm-twisting'' customers into buying some other product to get the product they desire. Examiners should focus on potentially illegal tie-in arrangements by reviewing (1) the banking organization's internal controls and procedures and its written policies and procedures in this area; (2) the training provided to the organization's staff; (3) pertinent extensions of credit to borrowers whose credit facilities or services may be susceptible to improper tie-in arrangements imposed by the bank or company in violation of section 106(b) or the Board's regulations; and (4) where applicable, the firewalls that have been established between banks and their holding companies and nonbank affiliates, including section 20 subsidiaries.

1. To determine if lending policies, practices, procedures, and internal controls for commercial and industrial loans are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the portfolio for credit quality, performance, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the Commercial Loan section of the Internal Control Questionnaire.
2. Based upon the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal/external auditors and determine if corrections have been accomplished.
4. Obtain a trial balance of the customer liability records and:
   a. Agree or reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination. Prepare credit line cards.
6. Obtain the following information from the bank or other examination areas, if applicable:
   a. Past-due loans.
   b. Loans in a nonaccrual status.
   c. Loans on which interest is not being collected in accordance with the terms of the loan. Particular attention should be given to loans which have been renewed with interest being rolled into principal.
   d. Loans whose terms have been modified by a reduction on interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms.
   e. Loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation or asset swap, since the previous examination.
   f. Loans acquired from another lending institution as a result of a purchase, participation or asset swap, since the previous examination.
   g. Loan commitments and other contingent liabilities.
   h. Loans secured by stock of other depository institutions.
   i. Extensions of credit to employees, officers, directors, principal shareholders and their interests, specifying which officers are considered executive officers.
   j. Extensions of credit to executive officers, directors, principal shareholders and their interests, of correspondent banks.
   k. A list of correspondent banks.
   l. Miscellaneous loan debit and credit suspense accounts.
   m. Shared national credits.
   n. Loans considered “problem loans” by management.
   o. Specific guidelines in the lending policy.
   p. Each officer’s current lending authority.
   q. Any useful information resulting from the review of the minutes of the loan and discount committee or any similar committee.
   r. Reports furnished to the loan and discount committee or any similar committee.
   s. Reports furnished to the board of directors.
   t. Loans classified during the previous examination.
   u. The extent and nature of loans serviced.
7. Review the information received and perform the following for:
   a. Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale/purchase, or asset swap:
      • Participations only:
        — Test participation certificates and records and determine that the parties share in the risks and contractual payments on pro rata basis.
        — Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
        — Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
      • Procedures pertaining to all transfers:
        — Investigate any situations where loans were transferred immediately prior to the date of examination to determine if any were trans-

ferred to avoid possible criticism during the examination.

- — Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
- — Determine that low-quality loans transferred to or from the bank are properly reflected on its books at fair market value (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium).
- — Determine that low-quality loans transferred to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.
- — If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
  - Name of originating institution.
  - Name of receiving institution.
  - Type of transfer (i.e., participation, purchase/sale, swap).
  - Date of transfer.
  - Total number of loans transferred.
  - Total dollar amount of loans transferred.
  - Status of the loans when transferred (e.g., nonperforming, classified, etc.).
  - Any other information that would be helpful to the other regulator.

b. Miscellaneous loan debit and credit suspense accounts:
- Discuss with management any large or old items.
- Perform additional procedures as deemed appropriate.

c. Loan commitments and other contingent liabilities:
- Analyze the commitment or contingent liability if the borrower has been advised of the commitment and the combined amount of the current loan balance (if any) and the commitment or other contingent liability exceeds the cutoff.

d. Loans classified during the previous examination:
- Current balance and payment status, or
- Date the loan was repaid and the source of payment.
- Investigate any situations where all or part of the funds for the repayment came from the proceeds of another loan at the bank, or as a result of a participation, sale or swap with another lending institution.
- If repayment was a result of a participation, sale or swap, refer to step 7a of this section for the appropriate examination procedures.

e. Review of leveraged buyouts:
- In evaluating individual loans and credit files, particular attention should be addressed to the reasonableness of interest-rate assumptions and earnings projections relied upon by the bank in extending the loan; the trend of the borrowing company's and the industry's performance over time and the history and stability of the company's earnings and cash flow, particularly over the most recent business cycle; the relationship between the company's cash-flow and debt-service requirements and the resulting margin of debt-service coverage; and the reliability and stability of collateral values and the adequacy of collateral coverage.
- In reviewing the performance of individual credits, examiners should attempt to determine if debt-service requirements are being covered by cash flow generated by the company's operations or whether the debt-service requirements are being met out of the proceeds of additional or ancillary loans from the bank designed to cover interest changes.
- Policies and procedures pertaining to leveraged buyout financing should be

reviewed to ensure that they incorporate prudent and reasonable limits on the total *amount* and *type* (by industry) of exposure that the bank can assume through these financing arrangements.
- The bank's pricing, credit policies, and approval procedures should be reviewed to ensure that rates are reasonable in light of the risks involved and that credit standards are not compromised in order to increase market share. Credit standards and internal review and approval standards should reflect the degree of risk and leverage inherent in these transactions.
- Total loans to finance leveraged buyouts should be treated as a potential concentration of credit and if, in the aggregate, they are sufficiently large in relation to capital, the loans should be listed on the concentrations page in the examination report.
- Significant deficiencies or risks regarding a bank's leveraged buyout financing should be discussed on page 1 of the examination report and brought to the attention of the board of directors.

f. Uniform Review of Shared National Credits:
- Compare the schedule of commercial credits included in the Uniform Review of National Credits program to the loans being reviewed to determine which loans are portions of shared national credits.
- For each loan so identified, transcribe appropriate information from the schedule to line cards. (No further examination procedures are necessary for these credits.)

8. Consult with the examiner responsible for the Asset/Liability Management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources. Refer to the Instructions for the Report of Examination section of this manual for considerations to be taken into account when compiling maturity information for the GAP analysis.
9. Transcribe or compare information from the schedules to commercial line cards, where appropriate.
10. Prepare commercial line cards for any loan not in the sample which, based on information derived from the above schedules, requires in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, lease financing, and other loan areas and together decide who will review the borrowing relationship.
12. Add collateral data to line cards selected in the preceding steps.
13. Obtain credit files for all borrowers for whom commercial line cards were prepared and complete line cards. To analyze the loans, perform the following procedures:
    a. Analyze balance-sheet and profit-and-loss items as reflected in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
    b. Review components of the balance sheet as reflected in the current financial statements and determine the reasonableness of each item as it relates to the total financial structure.
    c. Review supporting information for the major balance-sheet items and the techniques used in consolidation, if applicable, and determine the primary sources of repayment and evaluate their adequacy.
    d. Ascertain compliance with provisions of loan agreements.
    e. Review digest of officers' memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
    f. Relate collateral values to outstanding debt.
    g. Compare interest rates charged to the interest-rate schedule and determine that the terms are within established guidelines.
    h. Compare the original amount of loan with the lending officer's authority.
    i. Analyze secondary support afforded by guarantors and endorsers.
    j. Ascertain compliance with the bank's established commercial loan policy.
    k. Determine whether public officials are receiving preferential treatment and whether there is any correlation between loans to public officials and deposits they may control or influence.

14. For selected loans, check central liability file on borrowers indebted above the cutoff or borrowers displaying credit weakness or suspected of having additional liability in other loan areas.
15. Transcribe significant liability and other information on officers, principals and affiliations of appropriate borrowers contained in the sample. Cross-reference line cards to borrowers, where appropriate.
16. Prepare ''Report of Loans Supported by Bank Stock,'' if appropriate. Determine if a concentration of any bank's stock has been pledged.
17. Determine compliance with laws, rulings, and regulations pertaining to commercial lending by performing the following steps for:
    a. *Lending Limits:*
        - Determine the bank's lending limits as prescribed by state law.
        - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    b. *Section 23A, Federal Reserve Act (12 USC 371(c))—Transactions with Affiliates:*
        - Obtain a listing of loans to affiliates.
        - Test check the listing against the bank's customer liability records to determine its accuracy and completeness.
        - Obtain a listing of other covered transactions with affiliates (i.e., purchase of loans from affiliates or acceptance of affiliates' securities as collateral for loan to any person).
        - Ensure that covered transactions with affiliates do not exceed limits of section 23A.
        - Ensure that covered transactions with affiliates meet the appropriate collateral requirements of section 23A.
        - Determine that low quality loans have not been purchased from an affiliate.
        - Determine that all transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
    c. *18 USC 215—Commission or Gift for Procuring Loan:*
        - While examining the commercial loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
        - Investigate any such suspected situation.
    d. *Federal Election Campaign Act (2 USC 441b)—Political Contributions:*
        - While examining the commercial loan area, determine the existence of any loans in connection with any political campaigns.
        - Review each such credit to determine whether it is made in accordance with applicable banking laws and in the ordinary course of business.
    e. *12 USC 1972—Tie-In Provisions:*
        - While reviewing credit and collateral files (especially loan agreements) determine whether any extension of credit is conditioned upon:
            — Obtaining or providing an additional credit, property, or service to or from the bank or its holding company, other than a loan, discount, deposit, or trust service.
            — The customer not obtaining a credit, property or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit. (See ''Tie-In Considerations of the BHC Act,'' section 3500.0 of the *Bank Holding Company Supervision Manual*.)
    f. *Insider Lending Activities:* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows (the examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment):
        1. *Regulation O (12 CFR 215)—Loans to Executive Officers, Directors, Principal Shareholders, and Their Interests:*
            - While reviewing information relating to insiders received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps):
                — Test the accuracy and completeness of information about com-

mercial loans by comparing it to the trial balance or loans sampled.
- — Review credit files on insider loans to determine that required information is available.
- — Determine that loans to insiders do not contain terms more favorable than those afforded other borrowers.
- — Determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features.
- — Determine that loans to insiders, as defined by the various sections of Regulation O, do not exceed the lending limits imposed by those sections.
- — If prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained.
- — Determine compliance with the various reporting requirements for insider loans.
- — Determine that the bank has made provisions to comply with the public disclosure requirements of Regulation O.
- — Determine that the bank maintains records of such public requests and the disposition of the requests for a period of two years.

2. *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2))—Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks:*
   - Obtain from or request the examiners reviewing "Due from Banks" and "Deposit Accounts" to verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
   - Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.

g. *12 USC 1730—Loans Secured by Bank Stock:*
- While examining the commercial loan area, determine the existence of any loans secured by or to be secured by 25 percent or more of the outstanding voting stock or rights of an insured financial institution.
- In each case, determine that the chief executive officer has promptly reported such fact to the proper regulatory authority.

h. *12 USC 83 (Rev. Stat. 5201) made applicable to state member banks by section 9, para. 6 of the Federal Reserve Act (12 USC 324)—Loans Secured by Own Stock (See also section 3-1505 of FRRS):*
- While examining the commercial loan area, determine the existence of any loans secured by the bank's own shares or capital notes and debentures.
- Confer with examiner assigned "Investment Securities" to determine whether the bank owns any of its own shares or its own notes and debentures.
- In each case in which such collateral or ownership exists, determine whether the collateral or ownership was taken to prevent loss on a debt previously contracted (DPC) transaction.
- In each case of ownership, determine whether the shares or subordinated notes and debentures have been held for a period of not more than six months.

i. *Regulation U (12 CFR 221):* While reviewing credit files, check the following for all loans that are secured directly or indirectly by margin stock and were extended for the purpose of buying or carrying margin stock:
- Except for credits specifically exempted under Regulation U, determine that the required Form FR U-1 has been executed for each credit by the customer, and signed and accepted by a duly authorized officer of the bank acting in good faith.
- Determine that the bank has not extended more than the maximum loan value of the collateral securing such credits, as set by section 221.8 of Regulation U, and that the margin requirements are being maintained.

j. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103)—Retention of Credit Files:*
- Determine compliance with other spe-

cific exceptions and restrictions of the regulation as they relate to the credits reviewed.
- Review the operating procedures and credit file documentation and determine if the bank retains records of each extension of credit over $5,000, specifying the name and address of the borrower, the amount of credit, the nature and purpose of the loan and the date thereof. (Loans secured by an interest in real property are exempt.)

18. Determine whether the consumer compliance examination uncovered any violations of law or regulation in this department. If violations were noted, determine whether corrective action was taken. Test subsequent compliance with any law or regulation so noted.
19. Perform appropriate procedural steps in the Concentration of Credits section in this manual.
20. Discuss with appropriate officers and prepare summaries in appropriate report form of:
    a. Delinquent loans, segregating those considered ‘‘A’’ paper.
    b. Violations of laws and regulations.
    c. Loans not supported by current and complete financial information.
    d. Loans on which collateral documentation is deficient.
    e. Concentration of credits.
    f. Criticized loans.
    g. Inadequately collateralized loans.
    h. Small Business Administration or other government-guaranteed delinquent or criticized loans.
    i. Transfers of low-quality loans to or from another lending institution.
    j. Extensions of credit to principal shareholders, employees, officers, directors and related interests.
    k. Other matters regarding condition of department.
21. Inform the Reserve Bank of all criticized participation loans which are not covered by the shared national credit program. Include the names and addresses of all participating state member banks and copies of loan classification comments. (This step deals with loans that deteriorated subsequent to participation and does not duplicate step 7a which deals with transfers of loans that were of low quality when transferred).
22. Inform the Reserve Bank of those loans eligible for the shared national credit program which were not previously reviewed. Include the names and addresses of all participants and the amounts of their credit. (This step applies only to credits where the bank under examination is the lead bank.)
23. Evaluate the function with respect to:
    a. The adequacy of written policies relating to commercial loans.
    b. The manner in which bank officers are operating in conformance with established policy.
    c. Adverse trends within the commercial loan department.
    d. The accuracy and completeness of the schedules obtained from the bank.
    e. Internal control deficiencies or exceptions.
    f. Recommended corrective action when policies, practices or procedures are deficient.
    g. The competency of departmental management.
    h. Other matters of significance.
24. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for making and servicing commercial loans. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written commercial loan policies that:
   a. Establish procedures for reviewing commercial loan applications?
   b. Define qualified borrowers?
   c. Establish minimum standards for documentation?
2. Are commercial loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary commercial loan records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?
   c. Approve loans?
   d. Reconcile subsidiary records to the general ledger?

*4. Are the subsidiary commercial loan records reconciled daily with the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?

5. Are delinquent account collection requests and past-due notices checked to the trial balances that are used in reconciling commercial loan subsidiary records with general ledger accounts, and are they handled only by persons who do not also handle cash?

6. Are inquiries about loan balances received and investigated by persons who do not also handle cash?

*7. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash (if so, explain briefly)?

8. Is a daily record maintained summarizing note transaction details, i.e., loans made, payments received, and interest collected, to support applicable general ledger account entries?

9. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?

10. Is an overdue account report generated frequently (if so, how often ___________)?

11. Are subsidiary payment records and files pertaining to serviced loans segregated and identifiable?

12. Do loan records provide satisfactory audit trails which permit the tracing of transactions from initiation to final disposition?

LOAN INTEREST

*13. Is the preparation and posting of interest records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

14. Are any independent interest computations made and compared or tested to initial interest record by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

COLLATERAL

15. Are multicopy, prenumbered records maintained that:
   a. Detail the complete description of collateral pledged?
   b. Are typed or completed in ink?
   c. Are signed by the customer?
   d. Are designed so that a copy goes to the customer?

*16. Are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?

17. Is negotiable collateral held under joint custody?
18. Are receipts signed by the customer obtained and filed for released collateral?

*19. Are securities and commodities valued and margin requirements reviewed at least monthly?

20. When the support rests on the cash surrender value of insurance policies, is a periodic accounting received from the insurance company and maintained with the policy?
21. Is a record maintained of entry to the collateral vault?
22. Are stock powers filed separately to bar negotiability and to deter abstraction of both the security and the negotiating instrument?
23. Are securities out for transfer, exchange, etc., controlled by prenumbered temporary vault-out tickets?
24. Has the bank instituted a system which:
    a. Ensures that security agreements are filed?
    b. Ensures that collateral mortgages are properly recorded?
    c. Ensures that title searches and property appraisals are performed in connection with collateral mortgages?
    d. Ensures that insurance coverage (including loss payee clause) is in effect on property covered by collateral mortgages?
25. Are coupon tickler cards set up covering all coupon bonds held as collateral?
26. Are written instructions obtained and held on file covering the cutting of coupons?
27. Are coupon cards under the control of persons other than those assigned to coupon cutting?
28. Are pledged deposit accounts properly coded to negate unauthorized withdrawal of funds?
29. Are acknowledgments received for pledged deposits held at other banks?
30. Is an officer's approval necessary before collateral can be released or substituted?

OTHER

31. Are notes safeguarded during banking hours and locked in the vault overnight?
32. Are all loan rebates approved by an officer and made only by official check?
33. Does the bank have an internal review system that:
    a. Re-examines collateral items for negotiability and proper assignment?
    b. Checks values assigned to collateral when the loan is made and at frequent intervals thereafter?
    c. Determines that items out on temporary vault-out tickets are authorized and have not been outstanding for an unreasonable length of time?
    d. Determines that loan payments are promptly posted?
34. Are all notes assigned consecutive numbers and recorded on a note register or similar record? Do numbers on notes agree to those recorded on the register?
35. Are collection notices handled by someone not connected with loan processing?
36. Are payment notices prepared and mailed by someone other than the loan teller?
37. Does the bank prohibit the holding of debtor's checks for payment of loans at maturity?

*38. Concerning livestock loans:
    a. Are inspections made at the inception of credit?
    b. Are inspections properly dated and signed?
    c. Is there a breakdown by sex, breed, and number of animals in each category?
    d. Is the condition of the animals noted?
    e. Are inspections required at least annually?

*39. Concerning crop loans:
    a. Are inspections of growing crops made as loans are advanced?
    b. Are disbursements closely monitored to ensure that the proceeds are properly channeled into the farmer's operation?
    c. Is crop insurance encouraged?

40. In mortgage warehouse financing, does the bank hold the original mortgage note, trust deed, or other critical document, releasing only against payment?
41. Concerning commodity lending:
    a. Is control for the collateral satisfactory, i.e., stored in the bank's vault, another bank, or a bonded warehouse?
    b. If collateral is not stored within the bank, are procedures in effect to ascertain the authenticity of the collateral?
    c. Does the bank have a documented

security interest in the proceeds of the future sale or disposition of the commodity as well as the existing collateral position?

d. Do credit files document that the financed positions are and remain fully hedged?

42. Concerning loans to commodity brokers and dealers:
    a. Does the bank maintain a list of the major customer accounts on the brokers or dealers to whom it lends? If so, is the list updated on a periodic basis?
    b. Is the bank aware of the broker-dealer's policy on margin requirements and the basis for valuing contracts for margin purposes (i.e., pricing spot vs. future)?
    c. Does the bank attempt to ascertain whether the positions of the broker-dealer's clients that are indirectly financed by bank loans remain fully hedged?

CONCLUSION

43. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

44. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

Real estate lending is a major function of most banks. However, the composition of banks' real estate loan portfolios will vary because of differences in the banks' asset size, investment objectives, lending experience, market competition, and location. Additionally, state member banks' lending activity is subject to supervision by state banking regulatory agencies, which may impose limitations such as restrictions on lending territory, types of lending, percentage of assets in real estate loans, loan limits, loan-to-value ratios, and loan terms.

Because of the differences in state banking laws, this section of the manual provides only an overview of the Federal Reserve's supervisory and regulatory requirements for a safe and sound real estate lending program. For specific information on lending limitations and restrictions, refer to the applicable state banking laws. In addition, information related to real estate construction lending is discussed in section 2100.1 of this manual.

REAL ESTATE LENDING POLICY MANDATED BY FDICIA SECTION 304

A bank's real estate lending policy is a broad statement of its standards, guidelines, and limitations that senior bank management and lending officers are expected to adhere to when making a real estate loan. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation is essential to the bank's management of the lending function.

The policies governing a bank's real estate lending activities must include prudent underwriting standards that are clearly communicated to the institution's management and lending staff. The bank should also have credit-risk control procedures that include, for example, an effective credit-review and classification process and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. As part of the analysis of a bank's real estate loan portfolio, examiners should review lending policies, loan-administration procedures, and credit-risk control procedures, as well as the bank's compliance with its policy.

As mandated by section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the Federal Reserve Board, along with the other banking agencies, adopted in December 1992 uniform regulations prescribing standards for real estate lending. FDICIA defines real estate lending as extensions of credit secured by liens on or interests in real estate or made for the purpose of financing the construction of a building or other improvements to real estate, regardless of whether a lien has been taken on the property.

The Federal Reserve's Regulation H requires an institution to adopt real estate lending policies that are—

- consistent with safe and sound banking practices,
- appropriate to the size of the institution and the nature and scope of its operations, and
- reviewed and approved by the bank's board of directors at least annually.

These lending policies must establish—

- loan portfolio diversification standards;
- prudent underwriting standards that are clear and measurable, including loan-to-value limits;
- loan-administration procedures for the institution's real estate portfolio; and
- documentation, approval, and reporting requirements to monitor compliance with the bank's real estate lending policies.

Furthermore, the bank is expected to monitor conditions in the real estate market in its lending area to ensure that its policies continue to be appropriate for current market conditions.

GUIDELINES ESTABLISHED PURSUANT TO FDICIA SECTION 304

The criteria and specific factors that a bank should consider in establishing its real estate lending policies are set forth in the Interagency Guidelines for Real Estate Lending Policies, which is appendix C of Regulation H. These guidelines apply to transactions (including legally binding, but unfunded, lending commitments) originated on or after March 19, 1993.

Loan Portfolio Management

The bank's lending policy should contain a general outline of its market area; a targeted loan portfolio distribution; and the manner in which real estate loans are made, serviced, and collected. Lending policies should include—

- identification of the geographic areas in which the bank will consider lending;
- establishment of a loan portfolio diversification policy and limits for real estate loans by type and geographic market (for example, limits on higher-risk loans);
- identification of the appropriate terms and conditions by type of real estate loan;
- establishment of loan-origination and -approval procedures, both generally and by size and type of loan;
- establishment of prudent underwriting standards, including loan-to-value (LTV) limits, that are clear and measurable and consistent with the supervisory LTV limits contained in the interagency guidelines;
- establishment of review and approval procedures for exception loans, including loans with LTV ratios in excess of the interagency guidelines' supervisory limits;
- establishment of loan-administration procedures, including documentation, disbursement, collateral inspection, collection, and loan review;
- establishment of real estate appraisal and evaluation programs consistent with the Federal Reserve's appraisal regulation and guidelines; and
- a requirement that management monitor the loan portfolio and provide timely and adequate reports to the bank's board of directors.

The complexity and scope of these policies and procedures should be appropriate for the market, size, and financial condition of the institution and should reflect the expertise and size of the lending staff. The bank's policies should also consider the need to avoid undue concentrations of risk and compliance with all real estate–related laws and regulations (such as the Community Reinvestment Act, Truth in Lending Act, Real Estate Settlement Procedures Act, and antidiscrimination laws).

The bank should monitor the conditions in the real estate markets in its lending area so that it can react quickly to changes in market conditions that are relevant to the lending decision. This should include monitoring market supply-and-demand factors, such as employment trends; economic indicators; current and projected vacancy, construction, and absorption rates; and current and projected lease terms, rental rates, and sales prices.

Underwriting Standards

The bank's lending policies should reflect the level of risk that is acceptable to its board of directors, and provide clear and measurable underwriting standards that enable the bank's lending staff to evaluate all relevant credit factors. These factors include—

- the capacity of the borrower or income from the underlying property to adequately service the debt;
- the market value of the underlying real estate collateral;
- the overall creditworthiness of the borrower,
- the level of the borrower's equity invested in the property;
- any secondary sources of repayment; and
- any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or takeout commitments.

While there is no one lending policy appropriate for all banks, there are certain standards that a bank should address in its policy, such as—

- the maximum loan amount by type of property,
- the maximum loan maturities by type of property,
- amortization schedules,
- the pricing structure for each type of real estate loan, and
- loan-to-value limits by type of property.

For development and construction projects and completed commercial properties, the bank's policy should also establish appropriate standards for the unique risks associated with these types of real estate loans by addressing the size, type, and complexity of the project. Such standards should include the acceptability of and limits for nonamortizing loans and interest reserves; requirements for pre-leasing and presale; limits on partial recourse or nonrecourse loans; requirements for guarantor support; requirements for takeout commitments; and minimum covenants for loan agreements. Furthermore, the bank's policy should set minimum requirements for initial investment by the borrower; maintenance of hard equity throughout the life of the project; and net worth, cash flow, and debt-service coverage of the borrower or underlying property.

Exceptions to Underwriting Standards

The bank should have procedures for handling loan requests from creditworthy borrowers whose credit needs do not conform with the bank's general lending policy. As a part of the permanent loan file, the bank should document justification for approving such loans. Moreover, in the course of monitoring compliance with its own real estate lending policy, bank management should report to its board of directors loans of a significant size that are exceptions to bank policy. An excessive volume of exceptions to the institution's own policies may signal weaknesses in its underwriting practices or a need to revise its policy.

Supervisory Loan-to-Value Limits

The bank should establish its own internal loan-to-value (LTV) limits for each type of real estate loan that is permitted by its loan policy. The LTV ratio is derived at the time of loan origination by dividing the extension of credit, including the amount of all senior liens on, or other senior interests in, the property, by the total value of the property or properties securing or being improved by the extension of credit, plus the amount of any other acceptable collateral and readily marketable collateral securing the credit.

In accordance with the Federal Reserve's appraisal regulation and guidelines, the value of the real estate collateral should be set forth in an appraisal or evaluation (whichever is appropriate) and should be expressed in terms of market value. However, for loans to purchase an existing property, the term ‘‘value'' means the lesser of the actual acquisition cost to the borrower or the estimate of value as presented in the appraisal or evaluation. See ‘‘Real Estate Appraisals and Evaluations,'' section 4140.1 of this manual for further discussion of the Federal Reserve's appraisal regulation and guidelines.

‘‘Other acceptable collateral'' refers to any collateral in which the lender has a perfected security interest, that has a quantifiable value, and that is accepted by the lender in accordance with safe and sound lending practices. This includes inventory, accounts receivables, equipment, and unconditional irrevocable standby letters of credit.

Readily marketable collateral means insured deposits, financial instruments, and bullion in which the lender has a perfected interest. Financial instruments and bullion must be readily salable under ordinary circumstances at a market value determined by quotations based on actual transactions, on an auction, or similarly available daily bid and asking price.

Other acceptable collateral and readily marketable collateral should be appropriately discounted by the lender consistent with the bank's usual practices for making loans secured by such collateral. The lender may not consider the general net worth of the borrower, which might be a determining factor for an unsecured loan, as equivalent to other acceptable collateral for determining the LTV on a secured real estate loan. Furthermore, if an institution attempts to circumvent the supervisory LTV limits by lending a portion of the funds on a secured basis and a portion on an unsecured basis, examiners are instructed to consider the two loans as one if certain similarities are found. These similarities are based upon facts such as common origination dates or loan purposes, and should be used to determine compliance with the supervisory LTV limits. The bank's policy should reflect the supervisory limits set forth in the Interagency Guidelines for Real Estate Lending Policies, which are shown in the following table.

Table 1—Supervisory Loan-to-Value Limits

Loan Category	*Loan-to-Value Limit*
Raw land	65%
Land development, including improved land loans	75%
Construction:	
Commercial, multifamily, and other nonresidential	80%
One- to four-family residential	85%
Improved property	85%
Owner-occupied one- to four-family and home equity	**

** A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied one- to four-family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

For purposes of these supervisory limits, the loan categories are defined as follows:

Raw land loan means an extension of credit in which the funds are used to acquire and/or hold raw land.

Land development loan means an extension of credit for the purpose of improving unimproved real property before the erection of any structures. Such improvements include the laying or placement of sewers, water pipes, utility cables, streets, and other infrastructure necessary for future development. This loan category also includes an extension of credit for the acquisition of improved land, such as residential lots in an established development. If there are minimal improvements to the land, and the timeframe for construction of the dwelling or building has not been scheduled to commence in the foreseeable future, the loan generally should be considered a raw land loan.

Construction loan means an extension of credit for the purpose of erecting or rehabilitating buildings or other structures, including any infrastructure necessary for development.

One- to four-family residential loan means an extension of credit for a property containing fewer than five individual dwelling units, including manufactured homes permanently affixed to the underlying property.

Multifamily construction loan means an extension of credit for a residential property containing five or more individual units, including condominiums and cooperatives.

Improved property loan refers to (1) farmland, ranchland, or timberland committed to ongoing management and agricultural production; (2) one- to four-family residential property that is not owner-occupied; (3) residential property containing five or more individual dwelling units; (4) completed commercial property; or (5) other income-producing property that has been completed and is available for occupancy and use, except income-producing owner-occupied one- to four-family residential property.

Owner-occupied one- to four-family residential property means that the owner of the underlying real property occupies at least one unit of the real property as a principal residence.

For loans that fund multiple phases of the same real estate project, the appropriate LTV limit is the supervisory LTV limit applicable to the final phase of the project. For example, when the loan is for the acquisition and development of land and the construction of an office building in continuous phases of development, the appropriate supervisory LTV limit for the project loan would be 80 percent (the supervisory LTV limit for commercial construction). However, this does not imply that the lender can finance the total acquisition cost of the land at the time the raw land is acquired by assuming that this financing would be less than 80 percent of the project's final value. The lender is expected to fund the loan according to prudent disbursement procedures that set appropriate levels for the borrower's hard equity contributions throughout the disbursement period and term of the loan. As a general guideline, the funding of the initial acquisition of the raw land should not exceed the 65 percent supervisory LTV limit; likewise, the project cost to fund the land development phase of the project should not exceed the 75 percent supervisory LTV limit.

For a multiple-phase one- to four-family residential loan in which the lender is funding both the construction of the house and the permanent mortgage to a borrower who will be the owner-occupant, there is no supervisory LTV limit. However, if the LTV ratio equals or exceeds 90 percent, the bank should require an appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

When a loan is fully cross-collateralized by two or more properties, the maximum loan amount is determined by first multiplying each property's collateral value by the LTV ratio appropriate to that property and then deducting from that product any existing senior liens on that property. The resulting sum is the maximum loan amount that may be extended under cross-collateralization. To ensure that collateral margins remain within the supervisory limits, the bank should redetermine conformity whenever collateral substitutions are made to the collateral pool.

Loans in Excess of Supervisory LTV Limits

The Federal Reserve believes that it may be appropriate for a bank, in certain circumstances, to originate or purchase loans with LTV ratios in excess of supervisory limits, based on the support provided by other credit factors that the bank documented in its permanent credit files. While high LTV lending poses higher risk for lenders than traditional mortgage lending, high LTV lending can be profitable when these risks are effectively managed and loans are priced based on risk. Therefore, institutions involved in high LTV lending should implement risk-management programs that identify, measure, monitor, and control the inherent risks (see SR-99-26 and the attached ''Interagency Guidance on High LTV Residential Real Estate Lending,'' October 8, 1998). The primary credit risks associated with this type of lending are increased default risk and losses, inadequate collateral, longer term and thus longer exposure, and limited default remedies.

Capital limits. A bank's nonconforming loans—those in excess of the supervisory LTV limits—should be identified in bank records, and the aggregate amount, along with the performace experience of the portfolio, should be reported at least quarterly to the bank's board of directors. There should be increased supervisory scrutiny of a bank as its level of loans in excess of supervisory LTV limits approaches the capital limitations. Nevertheless, a nonconforming loan should not be criticized solely because it does not adhere to supervisory limits.

The aggregate amount of nonconforming loans may not exceed 100 percent of a bank's total risk-based capital (referred to as the nonconforming basket). Within this limit, the aggregate amount of non–one- to four-family residential loans (for example, raw land, commercial, multifamily, and agricultural loans) that do not conform to supervisory LTV limits may not exceed 30 percent of total risk-based capital. The remaining portion of the nonconforming basket includes the aggregate amount of one- to four-family residential development and construction loans, non-owner-occupied one- to four-family residential loans with an LTV ratio greater than 85 percent, and owner-occupied one- to four-family residential loans with an LTV ratio equal to or exceeding 90 percent without mortgage insurance or readily marketable collateral.

For the purpose of determining the loans subject to the 100 percent of risk-based capital limitation, and for the purposes of determining the aggregate amount of such loans, institutions should include loans that are secured by the *same* property, when the combined loan amount equals or exceeds 90 percent LTV and there is no additional credit support. In addition, institutions should include the recourse obligation of any such loan sold with recourse. If there is a reduction in principal or senior liens or if the borrower contributes additional collateral or equity that brings the LTV ratio into supervisory compliance, the loan is no longer considered nonconforming and may be deleted from the quarterly nonconforming loan report to the directors.

The following guidance is provided for calculating the LTV when multiple loans and more than one lender are involved. The institution should include its loan and all senior liens on or interests in the property in the total loan amount when calculating the LTV ratio. The following examples are provided:

- Bank A holds a first-lien mortgage on a property and subsequently grants the borrower a home equity loan secured by the same property. In this case, the bank would combine both loans to determine if the total amount outstanding equaled or exceeded 90 percent of the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, the entire amount of both loans is an exception to the supervisory LTV limits and is included in the aggregate capital limitation.

- Bank A grants a borrower a home equity loan secured by a second lien. Bank B holds a first-lien mortgage for the same borrower and on the same property. Bank A would combine the committed amount of its home equity loan with the amount outstanding on Bank B's first-lien mortgage to determine if the LTV ratio equaled or exceeded 90 percent of the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, Bank A's entire home equity loan is an exception to the supervisory LTV limits and is included in the aggregate capital limitation. Bank A does not report Bank B's first-lien mortgage loan as an exception, but must use it to calculate the LTV ratio.

When a loan's LTV ratio is reduced below 90 percent by amortization or additional credit support, it is no longer an exception to the guidelines and may be excluded from the institution's 100 percent of capital limitation.

Institutions will come under increased supervisory scrutiny as the total of all loans in excess of the supervisory LTV limits, including high LTV residential real estate loan exceptions, approaches 100 percent of total capital. If an institution exceeds the 100 percent of capital limit, a supervisory assessment may be needed to determine whether there is any concern that warrants taking appropriate supervisory action. Such action may include directing the institution (1) to reduce its loans in excess of the supervisory LTV limits to an appropriate level, (2) to raise additional capital, or (3) to submit a plan to achieve compliance. The institution's capital level and overall risk profile, and the adequacy of its controls and operations, as well as other factors will be the basis for determining whether such actions are necessary.

Transactions Excluded from Supervisory LTV Limits

There are a number of lending situations in which other factors significantly outweigh the need to apply supervisory LTV limits, thereby excluding such transactions from the application of the supervisory LTV and capital limits. This includes loans—

- guaranteed or insured by the U.S. government or its agencies, provided the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory LTV limit.
- backed by the full faith and credit of a state government, provided the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory LTV limit.
- guaranteed or insured by a state, municipal, or local government or agency, provided the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory LTV limit and that the guarantor or insurer has the financial capacity and willingness to perform.
- sold promptly (within 90 days) after origination. A supervisory determination may be made that this exclusion is not available for an institution that has consistently demonstrated significant weaknesses in its mortgage banking operations. (If a loan is sold with recourse and the LTV is in excess of supervisory limits, the recourse portion of the loan counts toward the bank's limit for nonconforming loans.)
- renewed, refinanced, or restructured—
  - — without the advancement of new monies (except reasonable closing costs); or
  - — in conjunction with a clearly defined and documented workout, either with or without the advancement of new funds.
- facilitating the sale of real estate acquired by the lender in the course of collecting a debt previously contracted in good faith.
- in which a lien on real property is taken through an abundance of caution; for example, the value of the real estate collateral is relatively low compared with the aggregate value of other collateral, or a blanket lien is taken on all or substantially all of the borrower's assets.[1]
- for working-capital purposes in which the lender does not rely principally on real estate as security. The proceeds of the loan are not

1. Any residential mortgage or home equity loan with an LTV ratio that equals or exceeds 90 percent and that does not have the additional credit support should be considered an exception to the guidelines and included in the calculation of loans subject to the 100 percent of capital limit.

used to acquire, develop, or construct real property.

- financing permanent improvements to real property, but in which no security interest is taken or required by prudent underwriting standards. For example, a manufacturing company obtains a loan to build an addition to its plant. The bank does not take a lien on the plant because the bank is relying on the company's operating income and financial strength to repay the debt.

Risk Management for Supervisory Loan-to-Value Limits

Loan review and monitoring. Institutions should perform periodic quality analyses through loan review and portfolio monitoring. These periodic reviews should include an evaluation of various risk factors, such as credit scores, debt-to-income ratios, loan types, location, and concentrations. At a minimum, the high LTV loan portfolios should be segmented by their vintage (that is, age) and the performance of the portfolios should be analyzed for profitability, growth, delinquencies, classifications and losses, and the adequacy of the allowance for loan and lease losses based on the various risk factors. The ongoing performance of the high LTV loans should be monitored by a periodic re-scoring of the accounts, or by periodically obtaining updated credit bureau reports or financial information on borrowers. In addition, institutions involved in high LTV lending should adopt, as part of their loan-review program, the standards in the FFIEC's uniform retail-credit classification and account-management policy. (See section 2130.1.)

Sales of high LTV loans. When institutions securitize and sell high LTV loans, all the risks inherent in such lending may not be transferred to the purchasers. Institutions that actively securitize and sell high LTV loans must implement procedures to control the risks inherent in that activity. Only written counterparty agreements that specify the duties and responsibilities of each party and that include a regular schedule for loan sales should be entered into. A contingency plan should be developed that designates back-up purchasers and servicers in the event that either party is unable to meet its contractual obligations. To manage liquidity risk, commitment limits should be established for the amount of pipeline and warehoused loans, and alternate funding sources should be identified.

Institutions should refer to the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 125 (FAS 125), ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,'' for guidance on accounting for these types of transactions. If a securitization transaction meets FAS 125 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights or obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations.

Compliance risk. Institutions that originate or purchase high LTV real estate loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory ''steering'' of borrowers to high LTV products for reasons other than the borrower's creditworthiness. An adequate compliance-management program must identify, monitor, and control the compliance risks associated with high LTV real estate lending.

REAL ESTATE LENDING ACTIVITY AND RISKS

Real estate lending falls into two broad categories: short-term financing (primarily construction loans) and permanent financing (for example, a 30-year residential mortgage or a 10-year mortgage loan with payments based on a 25-year amortization schedule and a balloon payment due at the end of the 10 years on an existing commercial office building). Each type of lending carries with it unique underwriting risks as well as common risks associated with any type of lending. In all cases, the bank should understand the credit risks and structure of the proposed transaction, even if it is not the originating bank. This includes, at a minimum, understanding the borrower's ability to repay the debt and the value of the underlying real estate collateral.

Permanent financing, as the name implies, is long term and presents a funding risk since a bank's source of funds is generally of a shorter maturity. Accordingly, bank management should be aware of the source for funding this lending activity. While matching the maturity structures of assets to liabilities is particularly important for a bank's overall loan portfolio management, the importance of this task is even more evident in real estate lending activity. Many banks reduce their funding risk by entering into loan participations and sales with other institutions as well as asset securitization transactions.[2] For a detailed discussion on short-term financing, see section 2100.1, "Real Estate Construction Loans."

Unsound Lending Practices

Some banks have adversely affected their financial condition and performance by granting loans based on ill-conceived real estate projects. Apart from losses due to unforeseen economic downturns, these losses have generally been the result of poor or lax underwriting standards and improper management of the bank's overall real estate loan portfolio.

A principal indication of an unsound lending practice is an improper relationship between the loan amount and the market value of the property; for example, a high loan-to-value ratio in relationship to normal lending practice for a similar type of property. Another indication of unsound lending practices is the failure of the bank to examine the borrower's debt-service ability. For a commercial real estate loan, sound underwriting practices are critical to the detection of problems in the project's plans, such as unrealistic income assumptions, substandard project design, potential construction problems, and a poor marketing plan, that will affect the feasibility of the project.

Real Estate Loan Portfolio Concentration Risk

A bank should have in place effective internal policies, systems, and controls to monitor and manage its real estate loan portfolio risk. An indication of improper management of a bank's portfolio is an excessive concentration in loans to one borrower or related borrowers, in one type of real estate loan, or in a geographic location outside the bank's designated trade area.

In identifying loan concentrations, commercial real estate loans and residential real estate loans should be viewed separately when their performance is not subject to similar economic or financial risks. However, groups or classes of real estate loans should be viewed as concentrations when there are significant common characteristics and the loans are affected by similar adverse economic, financial, or business developments. Banks with asset concentrations should have in place effective internal policies, systems, and controls to monitor and manage this risk.

Concentrations that involve excessive or undue risks require close scrutiny by the bank and should be reduced over a reasonable period of time. To reduce this risk, the bank should develop a prudent plan and institute strong underwriting standards and loan administration to control the risks associated with new loans. At the same time, the bank should maintain adequate capital to protect it from the excessive risk while restructuring its portfolio.

Loan Administration and Servicing

Real estate loan administration is responsible for certain aspects of loan monitoring. While the administration may be segregated by property type, such as residential or commercial real estate loans, the functions of the servicing department may be divided into the following categories (although the organization will vary among institutions):

- *Loan closing and disbursement*—preparing the legal documents verifying the transaction, recording the appropriate documents in the public land records, and disbursing funds in accordance with the loan agreement.
- *Payment processing*—collecting and applying the loan payments.
- *Escrow administration*—collecting insurance premiums and property taxes from the borrower and remitting the funds to the insurance company and taxing authority.

2. See section 4030.1, "Asset Securitization," for additional information, including information on mortgage-backed securities (MBS), collateralized mortgage obligations (CMOs), and real estate mortgage investment conduits (REMICs).

- *Collateral administration*—maintaining documents to reflect the status of the bank's lien on the collateral (i.e., mortgage/deed of trust and title policy/attorney's opinion), the value of the collateral (i.e., real estate appraisal or evaluation and verification of senior lien, if in existence), and the protection of the collateral (i.e., hazard/liability insurance and tax payments).
- *Loan payoffs*—determining the pay-off amount, preparing the borrower release or assumption documents, confirming the receipt of funds, and recording the appropriate lien-release documents in the public land records.
- *Collections and foreclosure*—monitoring the payment performance of the borrower and pursuing collection of past-due amounts in accordance with bank policy on delinquencies.
- *Claims processing*—seeking recoveries on defaulted loans that are covered by a government guarantee or insurance program or a private mortgage insurance company.

The bank should have adequate procedures to ensure segregation of duties for disbursal and receipt of funds control purposes. Additionally, the procedures should address the need for document control because of the importance of the timely recording of the bank's security interests in the public land records.

Some institutions provide various levels of loan services for other institutions, which may range from solely the distribution of payments received to the ultimate collection of the debt through foreclosure. In such cases, the bank will have the additional responsibility of remitting funds on a timely basis to the other institutions in accordance with a servicing agreement. The servicing agreement sets forth the servicer's duties, reporting requirements, timeframe for remitting funds, and fee structure. If a bank relies on another institution for servicing, the bank should have adequate control and audit procedures to verify the performance of the servicer (also see section 4030.1, ''Asset Securitization''). For residential loans sold into the secondary mortgage market for which the bank has retained servicing, Fannie Mae, Freddie Mac, and the Government National Mortgage Corporation (Ginnie Mae) have specific standards the bank (that is, seller/servicer) must adhere to. Failure to meet these standards can result in the termination of the servicing agreement.

BANK ASSESSMENT OF THE BORROWER

Although the value of the real estate collateral is an important component of the loan-approval process, the bank should not place undue reliance on the collateral value in lieu of an adequate assessment of the borrower's ability to repay the loan. These assessment factors differ depending upon the purpose of the loan, such as single-family residential loans as compared with income-producing commercial property loans and commercial or residential development loans (referred to as ''commercial real estate lending''). The loan documentation must adequately support the bank's assessment of the borrower and contain the appropriate legal documentation to protect the bank's interests.

Single-Family Residential Loans

For single-family residential loans, the bank should evaluate the loan applicant's creditworthiness and whether the individual has the ability to meet monthly mortgage payments as well as all other obligations and expenses associated with home ownership. This includes an assessment of the borrower's income, liquid assets, employment history, credit history, and existing obligations.[3] The bank should also consider the availability of private mortgage insurance; a government guarantee; or a government insurance program, such as loans through the FHA-insured or VA-guaranteed programs, in assessing the credit risk of a loan applicant.

If a bank delegates the loan-origination function to a third party, the bank should have adequate controls to ensure that its loan policies and procedures are being followed. The controls should include a review of the third party's qualifications; a written agreement between the bank and the third-party originator to set forth the responsibilities of the third party as an agent for the bank; a periodic review of the third party's operations to ensure that the bank's

3. There are restrictions on the information a bank can request. The Federal Reserve's Regulation B, Equal Credit Opportunity (12 CFR 202), details the information that may and may not be requested on a loan application and provides a model form for a residential mortgage transaction. The Federal Reserve's Regulation Z, Truth in Lending (12 CFR 226), describes the bank-disclosure requirements to the potential borrower on the cost of financing.

policies and procedures are being adhered to; and development of quality controls to ensure that loans originated by the third party meet the bank's lending standards, as well as those of the secondary mortgage market if the bank expects to sell the mortgages.

Secondary Residential Mortgage Market

In the secondary market, a bank (the primary mortgage originator) sells all or a portion of its interest in residential mortgages to other financial institutions (investors). Thus, the secondary mortgage market provides an avenue for a bank to liquidate a long-term asset as the need for funds arises. The majority of the secondary mortgage market activity is supported by three government-related or -controlled institutions: Fannie Mae,[4] Freddie Mac,[5] and Ginnie Mae.[6] These entities were created or sponsored by the federal government to encourage the financing and construction of residential housing. Fannie Mae, Freddie Mac, and Ginnie Mae have specific underwriting standards and loan-documentation requirements for mortgages purchased or guaranteed by them. Generally, financial institutions enter into either a mandatory or a standby commitment agreement with these entities wherein the financial institution agrees to sell loans according to certain delivery schedules, terms, and performance penalties.

Commercial Real Estate Loans

As with other types of lending activities, the extent of commercial real estate lending activity should be contingent upon the lender's expertise and the bank's experience. In considering an application for a commercial real estate loan, a bank should understand the relationship of the actual borrower to the project being financed. The form of business ownership varies for commercial real estate projects and can affect the management, financial resources available for the completion of the project, and repayment of the loan.

Information on past and current projects constructed, rented, or managed by the potential borrower can help the bank assess the borrower's experience and the likelihood of the proposed project's success. For development and construction projects, the bank should closely review the project's feasibility study. The study should provide sensitivity and risk analyses of the potential impact of changes in key economic variables, such as interest rates, vacancy rates, or operating expenses. The bank should also conduct credit checks of the borrower and of all principals involved in the transaction to verify relationships with contractors, suppliers, and business associates.

Finally, the bank should assess the borrower's financial strength to determine if the principals of the project have the necessary working capital and financial resources to support the project until it reaches stabilization. As with any type of lending on income-producing properties,[7] the bank should quantify the degree of protection from the borrower's (or collateral's) cash flow, the value of the underlying collateral, and any guarantees or other collateral that may be available as a source of loan repayment.

BANK ASSESSMENT OF REAL ESTATE COLLATERAL

Banks should obtain an appraisal or evaluation, as appropriate, for all real estate–related financial transactions before making the final credit or other decision. The Federal Reserve's appraisal regulation requires institutions to obtain appraisals when certain criteria are met. See ''Real

4. Although Fannie Mae was originally created in 1938 as an organization within the federal government, it became a federally chartered, stockholder corporation in 1968 when some of its functions were placed under the newly created Ginnie Mae. Financial institutions can either sell mortgages directly to Fannie Mae or pool mortgages for placement in a Fannie Mae–guaranteed mortgage-backed security.

5. Freddie Mac was sponsored by the Federal Home Loan Bank Board and its members in 1970. Its primary purpose is to provide a secondary market for conventional mortgages originated by thrifts.

6. Ginnie Mae, a government agency under the Department of Housing and Urban Development (HUD), was created in 1968 when Fannie Mae became a private corporation. It has several functions to assist in government housing programs, such as managing and liquidating loans acquired by the government. In the secondary market, Ginnie Mae acts as a guarantor of mortgage-backed securities for pools of loans originated and securitized by financial institutions.

7. Income-producing commercial properties include rental apartments, retail properties, office buildings, warehouses, and hotels.

Estate Appraisals and Evaluations'' section 4140.1, for a description of the related requirements a bank must follow for real estate–related financial transactions. The appraisal section explains the standards for appraisals, indicates which transactions require an appraisal or an evaluation, states qualifications for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal approaches.

Management is responsible for reviewing the reasonableness of the appraisal's or evaluation's assumptions and conclusions. Also, management's rationale for accepting and relying upon the appraisal or evaluation should be documented in writing. In assessing the underwriting risks, management should reconsider any assumptions used by an appraiser that reflect overly optimistic or pessimistic values. If management, after its review of the appraisal or evaluation, determines that there are unsubstantiated assumptions, the bank may request the appraiser or evaluator to provide a more detailed justification of the assumptions or obtain a new appraisal or evaluation.

Single-Family Residential Loans

The assessment of a residential property's market value is critical to the bank's estimate of loan-to-value ratio. This assessment provides the bank with an estimate of the borrower's equity in the property and the bank's potential credit risk if the borrower should default on the loan. For mortgages over $250,000, a bank is required to obtain an appraisal in conformance with the Federal Reserve's appraisal regulation. As of January 1, 1993, the appraisal must be performed by a state-certified or -licensed appraiser, as specified in the regulation. While transactions under $250,000 do not require an appraisal, a bank is expected to perform an appropriate evaluation of the underlying real estate collateral. Loans that are wholly or partially insured or guaranteed by a U.S. government agency or government-sponsored agency are exempt from the Federal Reserve's appraisal regulation, so long as the loan meets the underwriting requirements of the federal insurer or guarantor. Additionally, state laws for appraisals may differ from the Federal Reserve's requirements.

Loans qualifying for sale to any U.S. government agency or government-sponsored agency or conforming to the appraisal standards of Fannie Mae and Freddie Mac are also exempt from the Federal Reserve's appraisal regulation. Fannie Mae and Freddie Mac jointly developed and adopted the Uniform Residential Appraisal Report (URAR) as the standard form for residential loans sold to them. As a result, a properly completed URAR form is considered the industry standard for appraising one- to four-family residential properties.

Commercial Real Estate Loans

Due to the variety of uses and the complexity of most commercial projects, there is not a uniformly accepted format for valuing commercial properties like there is for valuing one- to four-family residential properties. A bank relies on outside appraisers, or in some instances in-house expertise, to prepare appraisals. For the most part, appraisals on commercial real estate projects are presented in a narrative format with supporting schedules. As the complexity of a commercial project increases, the detail of the appraisal report or evaluation should also increase to fully support the analysis.

When estimating the value of income-producing real estate, the appraiser generally relies to a greater degree on the income approach to valuation than on the comparable-sales approach or the cost approach. The income approach converts all expected future net operating income into present-value terms, using different analytical methods. One method, known as the direct capitalization method, estimates the present value of a property by discounting its stabilized net operating income at an appropriate capitalization rate (commonly referred to as a cap rate). Stabilized net operating income is the net cash flow derived from a property when market conditions are stable and no unusual patterns of future rents and occupancy are expected. To approximate stabilized net operating income, the appraiser or bank may need to adjust the current net operating income of a property either up or down to reflect current market conditions. The direct capitalization method is appropriate only for use in valuing stabilized properties.

Another method, known as the discounted cash-flow method, requires the discounting of expected future cash flows at an appropriate discount rate to ascertain the net present value of a property. This method is appropriate for use in estimating the values of new properties that have not yet stabilized, or for troubled properties that are experiencing fluctuations in income.

The discount rates and cap rates, used in estimating property values, should reflect reasonable expectations about the rate of return that investors and lenders require under normal, orderly, and sustainable market conditions. The appraiser's analysis and assumptions should support the discount and cap rates used in the appraisal. The appraiser should not use exaggerated, imprudent, or unsustainably high or low discount rates, cap rates, or income projections.

In assessing the reasonableness of the facts and assumptions associated with the valuation of commercial real estate, the bank should consider—

- current and projected vacancy and absorption rates;
- lease-renewal trends and anticipated rents;
- volume and trends in past-due leases;
- the project's feasibility study and market survey to determine support for the assumptions concerning future supply-and-demand factors;
- effective rental rates or sale prices (taking into account all concessions);
- net operating income of the property as compared with budget projections; and
- discount rates and direct capitalization rates.

Because the income approach is generally relied on to a greater degree than the other methods, with specific emphasis on arriving at stabilized values, the bank must use judgment in determining the time it will take for a property to achieve stabilized occupancy and rental rates. The analysis of collateral values should not be based on a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions.

The capacity of a property to generate cash flow to service a loan is evaluated on the basis of rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy, rental rates, and net operating income should be based on an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate.

EARLY INDICATIONS OF TROUBLED COMMERCIAL REAL ESTATE LOANS

Market-Related

To evaluate the collectibility of their commercial real estate portfolio, banks should be alert for economic indicators of weakness in their real estate markets as well as for indicators of actual or potential problems in the individual commercial real estate projects. Available indicators useful in evaluating the condition of the local real estate market include permits for and the value of new construction, absorption rates, employment trends, vacancy rates, and tenant lease incentives. Weaknesses disclosed by these types of statistics may signify that a real estate market is experiencing difficulties that may cause cash-flow problems for individual real estate projects, declining real estate values, and ultimately, troubled real estate loans.

Project-Related

Characteristics of potential or actual difficulties in commercial real estate projects may include—

- an excess supply of similar projects under construction in the same trade area.
- the lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- rent concessions or sales discounts, resulting in cash flow below the level projected in the original feasibility study, appraisal, or evaluation.
- concessions on finishing tenant space, moving expenses, and lease buyouts.
- slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- delinquent lease payments from major tenants.
- land values that assume future rezoning.
- tax arrearages.
- environmental hazards and liability for cleanup.

As the problems associated with a commercial real estate loan become more pronounced, the borrower/guarantor may experience a reduction in cash flow to service-related debts, which could result in delinquent interest and principal payments.

While some real estate loans become troubled because of a general downturn in the market, others become troubled because the loans were originated on an unsound or a liberal basis. Common examples of unsound loans include—

- loans with no or minimal borrower equity
- loans on speculative undeveloped property in which the borrower's only source of repayment is the sale of the property
- loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value
- additional advances to service an existing loan without evidence that the loan will be repaid in full
- loans to borrowers with no development plans or noncurrent development plans
- renewals, extensions, and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule[8]

EXAMINER REVIEW OF COMMERCIAL REAL ESTATE LOANS

The focus of an examiner's review of a real estate loan is on the ability of the loan to be repaid. The principal factors that bear on this review are the income-producing potential of the underlying collateral and the borrower's willingness and ability to repay the loan from other resources, if necessary, and according to existing loan terms. In evaluating the overall risk associated with a real estate loan, examiners should consider a number of factors, including the borrower's character, overall financial condition and resources, and payment history; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.[9] As the borrower's and guarantor's ability to repay a troubled real estate loan decreases, the importance of the collateral value of the loan increases commensurately.

Examiner Review of the Real Estate Collateral

An examiner's analysis of the collateral value is based on the bank's most recent appraisal or evaluation and includes a review of the major facts, assumptions, and approaches used by the appraiser or person performing the evaluation (including any comments made by management relative to the reasonableness of the appraisal or evaluation assumptions and conclusions). While the examiner may make adjustments to the assessment of value, these adjustments should be made solely for purposes of an examiner's analysis and assessment of credit quality and should not involve an adjustment to the actual appraisal or evaluation.

Furthermore, examiners should not make adjustments to appraisal or evaluation assumptions for credit-analysis purposes based on worst-case scenarios that are unlikely to occur. For example, an examiner should not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today's market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit-analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

Assumptions, when recently made by qualified appraisers or persons performing the evalu-

8. As discussed more fully in the section on classification guidelines, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. As consistent with sound banking practices, institutions should work appropriately and constructively with borrowers who may be experiencing temporary difficulties.

9. The primary basis for the review and classification of the loan should be the original source of repayment and the borrower's intent and ability to fulfill the obligation without relying on third-party guarantees. However, the examiner should also consider the support provided by any guarantees when determining the appropriate classification treatment for a troubled loan. The treatment of guarantees in the classification process is discussed in "Classification of Credits," section 2060.1.

ation and when consistent with the discussion above, should be given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and cap rates used in appraisals or evaluations, that differ only in a limited way from norms that would generally be associated with the property under review. However, the estimated value of the underlying collateral may be adjusted for credit-analysis purposes when the examiner can establish that underlying facts or assumptions are inappropriate and can support alternative assumptions.

CLASSIFICATION GUIDELINES

As with other types of loans, real estate loans that are adequately protected by the current sound worth and debt-service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. The examiner should focus on the ability of the borrower, guarantor, or the collateral to provide the necessary cash flow to adequately service the loan. The loan's record of performance is also important and must be taken into consideration. As a general principle, a performing real estate loan should not be automatically classified or charged off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. Conversely, the fact that the underlying collateral value equals or exceeds the current loan balance, or that the loan is performing, does not preclude the loan from classification if well-defined weaknesses jeopardize the repayment ability of the borrower, such as the lack of credible financial support for full repayment from reliable sources.[10]

Similarly, loans to sound borrowers that are refinanced or renewed according to prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be categorized as special mention unless potential weaknesses exist or should not be classified unless well-defined weaknesses exist that jeopardize repayment. An institution should not be criticized for working with borrowers whose loans are classified or categorized as special mention as long as the institution has a well-conceived and effective workout plan for such borrowers, along with effective internal controls to manage the level of these loans.

In evaluating real estate credits for special-mention categorization or classification, examiners should apply the standard definitions as set forth in ''Classification of Credits,'' section 2060.1. In assessing credit quality, examiners should consider all important information regarding repayment prospects, including information on the borrower's creditworthiness, the value of and cash flow provided by all collateral supporting the loan, and any support provided by financially responsible guarantors.

These guidelines apply to individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits in the same industry that are not affected by the problems of the troubled sectors.

Troubled Project-Dependent Commercial Real Estate Loans

The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment. As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can be clearly identified as uncollectible, should be classified loss. The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than substandard. The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified doubtful

10. Another issue that arises in the review of a commercial real estate loan is its accrual or nonaccrual treatment for reporting purposes. The federal banking agencies, under the auspices of the FFIEC, have provided guidance on nonaccrual status in the instructions for the Reports of Condition and Income (call reports) and in related supervisory guidance of the agencies. This guidance is summarized in ''Loan Portfolio Management,'' section 2040.1.

when the potential for full loss may be mitigated by the outcome of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined. If warranted by the underlying circumstances, an examiner may use a doubtful classification on the entire loan balance. However, this would occur infrequently.

Partially Charged-Off Loans

An evaluation based upon consideration of all relevant factors may indicate that a credit has well-defined weaknesses that jeopardize collection in full, although a portion of the loan may be reasonably assured of collection. When a charge-off has been taken in an amount sufficient to ensure that the remaining recorded balance of the loan (1) is being serviced (based upon reliable sources) and (2) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than substandard.

A more severe classification than substandard for the remaining recorded balance would be appropriate, however, if the loss exposure cannot be reasonably determined—for example, when significant risk exposures are perceived, such as in the case bankruptcy or loans collateralized by properties subject to environmental hazards. In addition, classifying the remaining recorded balance more severely than substandard would be appropriate when sources of repayment are considered unreliable.

Formally Restructured Loans

The classification treatment previously discussed for a partially charged-off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms.[11] Troubled commercial real estate loans whose terms have been restructured should be identified in the institution's internal credit-review system and closely monitored by management.

Home Equity Loans

Home equity loans (HELs) are defined as loans that are usually collateralized by a second mortgage or deed of trust on the borrower's principal residence or second residence; however, the collateral may be a first mortgage or deed of trust. The borrower's equity in the residence, pledged as collateral, provides protection for the loan and determines the maximum amount of credit that may be advanced. Traditionally, HELs were used to fund home improvements or to consolidate debt, and they were usually amortized without a revolving feature. Because of these characteristics, home equity loans were commonly maintained and administered in a bank's consumer or installment loan department and were monitored based on delinquency status. However, since enactment of the Tax Reform Act of 1986, which allows home equity loan interest of up to $100,000 to be deducted from a taxpayer's gross income, the popularity and usage of HELs have expanded considerably. The proceeds of home equity loans are now used for increasingly diverse purposes, such as consumer purchases, personal investments, working capital for small businesses, and a supplement to personal income.

The structure and repayment terms of home equity loans have become more varied. Amortization periods may be as long as 15 years, with possible balloon maturities of three to five years. In some instances, the payment requirement is only interest due for an initial period. Revolving lines of credit have also gained popularity as a way to accommodate the many different uses of loan proceeds. Lines of credit to individuals with high incomes or high net worths may substantially exceed $100,000. These loans are often housed in the bank's private-banking

11. An example of a restructured commercial real estate loan that does not have reasonable modified terms would be a cash-flow mortgage, which requires interest payments only when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

division or within the commercial loan portfolio, rather than in the consumer loan department.

In addition to the increasingly varied purposes of HELs, there has also been an upsurge in loans in which the combined first and second mortgages result in very high LTV ratios. To remain competitive with other residential lenders, some banks have relaxed their underwriting standards by permitting higher LTV ratios. In addition, some banks may have offset declines in residential mortgage refinancing during periods of higher interest rates by competing more aggressively for home equity loan business. Consumer demand for HELs may also increase during periods of higher interest rates because they provide an alternative source of financing for consumer purchases.

Examiners must ensure that a bank's policies for originating and acquiring HELs comply with the real estate lending standards and guidelines stipulated in the Board's Regulation H, subpart C. While the guidelines permit banks to make residential real estate loans with LTV ratios in excess of 90 percent without the appropriate credit enhancements, these loans are treated as exceptions to the guidelines and are subject to the aggregate limitation of 100 percent of the bank's total capital.

As with all types of lending, the bank should have strong underwriting standards for HELs. In assessing these standards, the examiner should determine whether the bank primarily emphasizes the borrower's ability and willingness to repay the loan from income or cash flow versus the amount of equity in the real estate. Extended repayment terms and liberal loan structures can increase the risk of default on HELs. Normally, longer repayment terms increase the likelihood of events that could jeopardize the borrower's ability to repay, for example, the loss of a job, a change in marital status, a prolonged spike in prevailing interest rates, or a deflationary economic environment. Additionally, the examiner should review the bank's policy (or practice) for obtaining appraisals or evaluations to determine the lendable equity in the borrower's residence. The examiner should determine that the bank has not relaxed its appraisal requirements to accommodate the growth of its HEL portfolio. For example, a bank's reliance on drive-by appraisals rather than full appraisals or evaluations could represent an unsafe and unsound practice depending on the size of the loan, the total volume of HELs, and the condition of the local real estate market.

Economic periods of increasing unemployment, rising interest rates, or other recessionary factors can negatively affect the repayment ability of borrowers and erode the value and marketability of residential real estate. Moreover, most HELs are collateralized by junior lien positions. Therefore, if the bank forecloses, it must pay off or service the senior mortgage lender, further increasing its exposure. Foreclosure proceedings may entail lengthy and costly litigation, and real estate law commonly protects the home owner.

Examiners should ensure that banks have proper controls to manage this exposure, particularly those that have a high concentration of home equity loans with excessively high combined LTV ratios. Banks with concentrations that lack proper controls and monitoring procedures should be criticized for these credit deficiencies. If the examiner judges the deficiencies to be severe, the bank should be cited for unsafe and unsound banking practices.

ALLOWANCE FOR LOAN AND LEASE LOSSES

A bank bases the adequacy of its allowance for loan and lease losses (ALLL), including amounts resulting from an analysis of the real estate portfolio, on a careful, well-documented, and consistently applied analysis of its loan and lease portfolio.[12] Guidance related to the ALLL is primarily addressed in the section 2070.1. The following discussion summarizes general principles for assessing the adequacy of the ALLL.

Examiners should evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL to ensure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the examiner should review the reasonableness of management's overall estimate of the ALLL, as well as the range of possible credit losses, by taking into account these factors. The examiner's anal-

12. The estimation process described in this section permits a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.

ysis should also consider the quality of the bank's systems and management's ability to identify, monitor, and address asset-quality problems.

As discussed in the previous subsection on classification guidelines, examiners should consider the value of the collateral when reviewing and classifying a loan. For a performing commercial real estate loan, however, the supervisory policy does not require automatic increases to the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

In assessing the ALLL during examinations, it is important that the examiner recognize that management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan-administration and collection procedures and effective internal systems and controls, the estimation of anticipated losses may not be precise due to the wide range of factors that must be considered. Furthermore, the ability to estimate anticipated losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. The examiner should give considerable weight to management's estimates in assessing the adequacy of the ALLL when management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems, and (2) analyzed all significant factors affecting the collectibility of the portfolio.

REGULATORY COMPLIANCE

Banks are expected to comply with laws, regulations, and Federal Reserve policy in all aspects of their real estate lending programs. Moreover, banks should establish adequate internal controls to detect deficiencies or exceptions to their lending policy that result in unsafe and unsound lending practices. In regard to lending limits, the examiner should review the bank's lending practices in accordance with the applicable state laws in the following areas that prescribe limits on aggregate advances to a single borrower and related borrowers:

Transactions with affiliates. All transactions with affiliates should be on terms and conditions that are consistent with safe and sound banking practices. The bank is expected to comply with the limits and collateral requirements of sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 371c-1).

Tie-in provisions. Section 106 of the Bank Holding Company Act Amendments states that a bank is prohibited from fixing or varying the consideration for extending credit, leasing or selling property of any kind, or furnishing any service on the condition or requirement that the customer—

- obtain additional credit, property, or service from the bank, other than a loan, discount, deposit, or trust service (a ‘‘traditional bank product’’);
- obtain additional credit, property, or service from the bank's parent holding company or the parent's other subsidiaries;
- provide additional credit, property, or service to the bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;
- provide additional credit, property, or service to the bank's parent holding company or any of the parent's other subsidiaries; or
- not obtain other credit, property, or service from the competitors of the bank, the bank's parent holding company, or the parent's other subsidiaries, except that the lending bank may impose conditions and requirements in a credit transaction to ensure the soundness of the credit.

See the statutory exceptions in section 106(b) of the Bank Holding Company Act Amendments and the Federal Reserve's Regulation Y, (12 CFR 225.7).

Insider lending activities. Loans to insiders should not contain more favorable terms than those afforded to other borrowers nor pose a more-than-normal risk of repayment. The bank is expected to maintain adequate loan documentation of insider loans showing that proper approval for the loan was obtained. Such loans should comply with the Federal Reserve's Regulation O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks (12 CFR 215, subpart B).

Loans to executives, officers, directors, and principal shareholders of correspondent banks. There should be no preferential treatment on loans to insiders of correspondent banks nor should there be the appearance of a conflict of interest. The bank should comply with title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)).

Appraisals and evaluations. Banks should obtain an appraisal or evaluation for all real estate–related financial transactions before making the final credit decision in conformance with title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (12 USC 3310, 3331–3351) and the Federal Reserve's Regulation H, Membership of State Banking Institutions in the Federal Reserve System (12 CFR 208), as set forth in subpart G of Regulation Y (12 CFR 225). The Federal Reserve's appraisal and evaluation requirements are separately discussed in section 4140.1, ''Real Estate Appraisals and Evaluations.''

Consumer compliance. The bank's residential lending program should ensure that the loan applicant is adequately informed of the annual interest rate, finance charges, amount financed, total payments, and repayment schedule as mandated in the Federal Reserve's Regulation Z, Truth in Lending (12 CFR 226). The bank's process for taking, evaluating, and accepting or rejecting a credit application is subject to the Federal Reserve's Regulation B, Equal Credit Opportunity (12 CFR 202).

1. To determine if policies, practices, procedures, and internal controls regarding real estate loans are adequate to identify and manage the risks the bank is exposed to.
2. To ascertain if the institution has implemented risk-management programs that identify, measure, monitor, and control the inherent risks involved in real estate lending.
3. To determine if bank officers and staff are operating in conformance with the bank's established guidelines.
4. To evaluate the portfolio for collateral sufficiency, performance, credit quality, and collectibility.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

1. Determine the scope of the examination based upon the evaluation of internal controls and the work performed by internal/external auditors.
2. Review the board of directors minutes to ensure that real estate loan policies are reviewed and approved at least annually.
3. Test real estate loans for compliance with policies, practices, and procedures by performing the remaining examination procedures in this section. Obtain a listing of any deficiencies noted in the latest internal/external audit report and determine if appropriate corrections have been made. Additionally, obtain a list of personnel changes and determine if these changes are significant enough to influence the scope of the examination.
4. Obtain a trial balance and delinquency listing for all real estate loans and—
   a. reconcile the real estate department's trial balance totals to the bank's general ledger accounts;
   b. review reconciling items for reasonableness; and
   c. obtain information (for example, paid-to dates, last date paid, and date of nonaccrual status) on past-due loans and loans on nonaccrual status.
5. Evaluate the bank with respect to—
   a. the adequacy of written policies and procedures relating to real estate loans;
   b. the operating compliance with established bank policy;
   c. favorable or adverse trends in the overall real estate lending activity;
   d. the accuracy and completeness of the bank's records;
   e. the adequacy of internal controls;
   f. adherence to lending policies, procedures, and authority by all appropriate personnel;
   g. compliance with laws, regulations, and Federal Reserve policy on real estate lending activity, including lending limits and restrictions; loans to officers, directors, and shareholders; appraisal and evaluation of real estate collateral; and lending practices;
   h. compliance with the Interagency Guidelines for Real Estate Lending Policies, including whether the bank is adequately documenting exceptions to supervisory loan-to-value (LTV) limits, whether the volume of nonconforming loans exceeds the capital limitations, and whether risk-management programs have been established and maintained to identify, measure, monitor, and control the inherent risks associated with high LTV lending; and
   i. other matters of significance, including mortgage servicing, warehousing operations, and the loan origination/resale process.
6. Select loans for examination using an appropriate sampling technique drawn from judgmental (cut-off amount approach) or statistical sampling. Analyze the performance of the loans selected for review by transcribing the appropriate information from the following list onto the real estate loan line cards, when applicable:
   a. collateral records and credit files
   b. loan agreements relative to any purchases, transfers, participations, or sales that have been entered into since the last examination
   c. loan commitments and other contingent liabilities
   d. loan modification agreements or restructuring terms to identify a reduction in interest rate or principal payments, deferral of interest or principal payments, or other restructurings of terms
   e. past-due/nonaccrual–related information
   f. loan-specific internal problem credit analyses information
   g. escrow analysis reports, including the status of property tax payments and escrow advances by the bank to cover delinquent property taxes
   h. the status of mortgage insurance claims either for government insurance or guarantee programs or for private mortgage insurance, including procedures for ensuring coverage and reporting procedures for filing claims and contested claims, if any
   i. loans to insiders and their interests
7. In analyzing the selected real estate loans, consider the following procedures, taking

appropriate action if necessary:

a. Determine the primary source of repayment and evaluate its adequacy.
b. Assess the quality of any secondary collateral afforded by the loan guarantors or partners.
c. Compare collateral values with outstanding debt and determine whether the loan's LTV ratio is in excess of the supervisory LTV limits. If so, ascertain whether the loan has been properly reported as a nonconforming loan.
d. Assess the adequacy of the appraisal or evaluation.
e. Ascertain whether the loan complies with established bank policy.
f. Identify any deficiencies in the loan's documentation both in the credit files and in the collateral records.
g. Identify whether the loan is to an officer, director, or shareholder of the bank or a correspondent bank and whether an officer, director, or shareholder of the bank is a guarantor on the loan.
h. Review the borrower's compliance with provisions of the loan agreement and the borrower's payment performance, indicating whether the loan is past due.
i. Determine if there are any problems that may jeopardize the repayment of the real estate loan.
j. Determine whether the loan was classified during the preceding examination, and, if the loan has been paid off, whether all or part of the funds for repayment came from another loan at the bank, from a participation or sale with another institution, or from the repossession of the property.
k. Identify whether the loan is to a firm or to individuals who are principals of a firm that provided professional services to the bank, including attorneys, accountants, and appraisers. If so, determine if the loan has received preferential treatment.

8. For loan participations, either in whole or in part, to or with another lending institution, review, if applicable—
   a. participation certificates and agreements, on a test basis, to determine if the contractual terms are being adhered to;
   b. loan documentation to see if it meets the bank's underwriting procedures as if the loan had been originated by the bank;
   c. the transfer of loans immediately before the date of the examination to determine if the loan was either nonperforming or classified and if the transfer was made to avoid possible criticism during the current examination; and
   d. losses to determine if such losses are shared on a pro rata basis.
9. For participations between an institution with a different primary regulator and the shared national credit program loans—
   a. identify loans to be included in the shared national credit review;
   b. inform the Reserve Bank of any criticized participation loans that were not covered by the shared national credit program and in which the participant(s) has a different primary regulator; and
   c. inform the Reserve Bank of those loans eligible for the shared national credit program that were not previously reviewed.
10. In connection with the examination of other lending activity in the bank—
    a. check the central liability file on the borrower(s) and determine whether the total indebtedness of the borrower exceeds the lending limit to a single borrower; and
    b. obtain information and related performance status on common borrowers and their interests from examiners assigned to other examination areas (such as non–real estate loans, leasing, overdrafts, and cash items) and determine the total indebtedness of the borrower to the bank. Additionally, one examiner should be assigned to review the borrower's overall borrowing relationship with the bank.
11. Consult with the examiner responsible for the asset/liability management analysis portion of the examination to determine the appropriate maturity breakdown of real estate loans needed for the analysis, and prepare the necessary schedules.
12. Summarize the findings of the real estate loan portfolio review and address the following:
    a. the scope of the examination
    b. the quality of the policies, procedures, and controls
    c. the general level of adherence to policies and procedures
    d. the competency of management and loan officers, including identification of indi-

viduals with an excessively high level of problem loans or documentation exceptions
e. the quality of the loan portfolio
f. loans not supported by current and complete financial information
g. loans with incomplete documentation, addressing deficiencies related to items such as appraisals or evaluations, title policy, proof of insurance, deeds of trust, and mortgage notes
h. loans to officers, directors, shareholders, or their interests
i. causes of existing problems
j. delinquent loans and the aggregate amount of statutory bad debts. (See section 2060.1, ''Classification of Credits.'')
k. concentrations of credits
l. classified loans
m. violations of laws, regulations, and Federal Reserve policy
n. action taken by management to correct previously noted deficiencies and corrective actions recommended to management at this examination, with the bank's response to them

Review the bank's internal controls, policies, practices, and procedures for making and servicing real estate loans. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Negative responses to the questions in this section should be explained, and additional procedures deemed necessary should be discussed with the examiner-in-charge. Items marked with an asterisk require substantiation by observation or testing.

LOAN POLICIES

1. Has the board of directors and management, consistent with their duties and responsibilities, adopted and, at least annually, reviewed and approved written real estate loan policies that define—
   a. the institution's target market?
   b. loan portfolio diversification standards?
   c. acceptable collateral types?
   d. prudent, clear, and measurable underwriting standards, including relevant credit factors such as—
      - maximum loan amount by type of property?
      - maximum loan maturity by type of property?
      - repayment terms?
      - pricing structure for each type of real estate loan?
      - loan-to-value (LTV) limits by type of property?

   e. procedures for reviewing real estate loan applications?
   f. loan-origination and -approval procedures (including loan authority limits) by size and type of loan?
   g. review and approval procedures for exception loans?
   h. loan-administration procedures that include documentation, disbursement, collateral inspection, collection, and loan review?
   i. minimum loan-documentation standards, such as minimum frequency and type of financial information required for each category of real estate loan?
   j. LTV limits that are consistent with regulatory supervisory limits?
   k. real estate appraisal and evaluation programs consistent with the Federal Reserve's appraisal regulation and guidelines?
   l. reporting requirements to the board of directors relative to loan portfolio monitoring, including items such as compliance with lending policies and procedures, delinquency trends, and problem loans?
2. Are real estate policies and objectives appropriate to the size and sophistication of the bank, and are they compatible with changing market conditions?

LOAN RECORDS

*3. Are the preparation and posting of subsidiary real estate loan records performed or adequately reviewed by persons who do not also—
   a. issue official checks and drafts?
   b. handle cash receipts?
   c. reconcile subsidiary records to general ledger controls?

*4. Are the subsidiary real estate loan records reconciled at least monthly to the appropriate general ledger accounts? Are reconciling items adequately investigated by persons who do not also handle cash or prepare/post subsidiary controls?

5. Are loans in excess of supervisory LTV limits identified in the bank's records, and are the aggregate amounts of such loans reported at least quarterly to the board of directors, along with the experience of the high LTV loan portfolio?
6. Are loan statements, delinquent account collection requests, and past-due notices reconciled to the real estate loan subsidiary records? Are the notices and reconciliations handled by persons who do not also handle cash?
7. Are inquiries about loan balances received and investigated by persons who do not also handle cash?

*8. Are documents supporting recorded credit adjustments subsequently checked or tested by persons who do not also handle cash?
9. Does the bank maintain a daily record summarizing note transaction details (loans made, payments received, and interest collected) to support applicable general ledger account entries?
10. Are note and liability trial balances frequently reconciled to the general ledger by employees who do not process or record loan transactions?
11. Are subsidiary payment records and files pertaining to serviced loans segregated and identifiable?
12. Are past-due loan reports generated daily?

LOAN INTEREST AND COMMITMENT FEES

*13. Are the preparation and posting of loan interest and fee records performed or adequately reviewed by persons who do not also—
  a. issue official checks or drafts?
  b. handle cash?
14. Are any independent interest and fee computations made and compared with or adequately tested to loan interest records by persons who do not also—
  a. issue official checks or drafts?
  b. handle cash?

PROCESSING AND DOCUMENT CONTROL

*15. Are all real estate loan commitments issued in written form?
16. Are loan officers prohibited from processing loan payments?
*17. Are loan payments received by mail recorded upon receipt independently before being sent to and processed by a note teller?
*18. Regarding mortgage documents—
  a. Has the responsibility for the document files been established?
  b. Does the bank use a check sheet to ensure that required documents are received and on file?
  c. Are safeguards in effect to protect notes and other documents?
  d. Does the bank obtain a signed application form for all real estate mortgage loan requests?
  e. Are separate credit files maintained?
  f. Is there a program of systematic follow-up to determine that all required documents are received after the loan closing and from public recording offices?
  g. Does a designated employee conduct a review after loan closing to determine if all documents are properly drawn, executed, recorded, and filed within the loan files?
  h. Are all notes and other instruments pertaining to paid-off loans returned promptly to the borrower, cancelled, and marked paid, where appropriate?
  i. Are charged-off notes and related files segregated and adequately controlled?

LOAN ORIGINATION

19. Does the bank have a written schedule of fees, rates, terms, and types of collateral for all new loans?
20. Does the bank have a mortgage errors and omission policy?
21. Are procedures in effect to ensure compliance with the requirements of governmental agencies that insure or guarantee loans or with the requirements of private mortgage insurance companies?

ESCROW PROCESSING

22. Regarding insurance and property taxes coverage—
  a. Is there a procedure for determining that private mortgage insurance premiums are current on insured loans?
  b. Is there a procedure for determining that property and hazard insurance premiums are current on properties securing loans?
  c. Does the bank require that the hazard insurance policies include a loss payable clause to the bank?
  d. Are escrow accounts reviewed at least annually to determine if monthly deposits will cover anticipated disbursements?

e. Are disbursements for taxes and insurance supported by records showing the nature and purpose of the disbursement?
f. If advance deposits for taxes and insurance are not required, does the bank have a system to determine that taxes and insurance are being paid?

LOAN ADMINISTRATION

*23. Are approvals of real estate advances reviewed, before disbursement, to determine that such advances do not increase the borrower's total liability to an amount in excess of the bank's legal lending limit?
24. Are detailed statements of account balances and activity mailed to mortgagors at least annually?

COLLECTIONS AND FORECLOSURES

25. Does the bank have adequate collection procedures to monitor delinquencies and, as necessary, procedures to pursue foreclosure?
26. Are properties under foreclosure proceedings segregated?
27. Are properties to which the bank has obtained title appropriately transferred to other real estate owned (OREO)? See "Other Real Estate Owned," section 2200.1, for requirements.
28. Does the bank have an adequate management and sales disposition program for timely liquidation of OREO that takes into account the maximum retention period for OREO allowed under state law?
29. Does the bank have adequate procedures for filing and monitoring its mortgage insurance claims for government-insured or -secured programs and for private mortgage insurance?

CONCLUSION

30. Does the foregoing information provide an adequate basis for evaluating internal control in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
31. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?